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EFFECT OF TEFRA ON PRIVATE PENSION PLANS

HEARING

BEFORE THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

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EFFECT OF TEFRA ON PRIVATE PENSION PLANS

MONDAY, APRIL 11, 1983

U.S. SENATE,
SUBCOMMITTEE ON SAVINGS, PENSIONS,
AND INVESTMENT POLICY,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, Hon. John Chafee (chairman) presiding.

Present: Senator Chafee.

[The press release announcing the hearing and Senator Dole's opening statement follow:]

FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY SETS HEARINGS ON THE EFFECT ON PRIVATE PENSION PLANS OF PENSION PROVISIONS IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Senator John H. Chafee (R., R.I.), Chairman of the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on April 11, 1983, on the effect of changes made in the Tax Equity and Fiscal Responsibility Act of 1982 on the private pension system.

The hearings will begin at 9:30 a.m. on April 11, 1983, in SD-215 (formerly Room 2221) of the Dirksen Senate Office Building.

In announcing the hearing, Senator Chafee noted that "the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") made significant changes in both corporate and noncorporate pension plans. These changes are intended to prevent excess accumulations of tax-deferred funds by high-income individuals, to reduce incentives to use pension plans as a method of sheltering income from tax, and to eliminate artificial distinctions and to create more parity between corporate and noncorporate pension plans."

Several groups have expressed concern about the effect of some of the changes on various types of pension plans. In addition, Chafee noted that, "the effective date of the parity provisions was delayed until 1984 so the Congress would have an opportunity to review the effect these changes may have on private pension plans. This hearing will provide all interested parties an opportunity to comment on the effect of these provisions on different plans."

Chafee also noted that "while TEFRA addressed abuses in pension law and overly generous tax incentives, great care was taken in an attempt to insure that the changes in TEFRA will not jeopardize our private pension system. The hearing will provide industry representatives an opportunity to comment on the balance struck by Congress in TEFRA and its effect on the future growth of the private pension system."

Requests to testify.—Witnesses who wish to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room SD-221, Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on Wednesday, April 6, 1983. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such a case, a witness should notify the Committee as soon as possible of his inability to appear.

Consolidated testimony.—Senator Chafee urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Chafee urges that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act.—Senator Chafee stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument".

Witnesses scheduled to testify should comply with the following rules: (1) All witnesses must submit written statements of their testimony, (2) written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be delivered not later than noon on Friday, April 8, 1983, (3) all witnesses must include with their written statements a summary of the principal points included in the statement, (4) oral presentation should be limited to a short discussion of principal points included in the one-page summary. Witnesses must not read their written statements. The entire prepared statement will be included in the record of the hearing, and (5) not more than 5 minutes will be allowed for the oral summary.

Written statements.—Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room SD-221, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, April 25, 1983. On the first page of your written statement, please indicate the date and subject of the hearing.

STATEMENT OF SENATOR DOLE

I understand that some witnesses have voiced some serious policy concerns about the pension changes included in TEFRA. These changes were rather sweeping and it may be argued that the final rules caught some people by surprise.

However, the Senate conferees understood this potential criticism and argued successfully for a one year delay in the "top-heavy" rules. The delayed effective date allowed time for this hearing and I appreciate your comments.

The philosophical basis behind the top-heavy rules is to assure that pension benefits will be available across a broad spectrum of employees—not limited primarily to the officers and highly compensated employees.

Commentators and some members of Congress had suggested more drastic approaches such as elimination or limitation of integration with social security and faster vesting of benefits.

TEFRA did not go that far. However, in an attempt to more carefully target pension changes to the cases with the greatest likelihood of abuse, the TEFRA rules did result in substantial complexity.

Your testimony today will help us to determine whether these rules can be simplified while still addressing the problems which led to the enactment of TEFRA.

Senator CHAFEE. We welcome everybody here this morning. This is a hearing of the Subcommittee on Savings, Pensions, and Investment Policy, and we are dealing with the TEFRA pension provisions that we passed last year.

In some respects I suppose the critics could say we are closing the barn door after the horse is out since this is an ex post facto hearing, the deed having taken place last year. As you recall, we were faced with the need for additional revenue last year to make some effort to control the deficits that were facing us, and so we passed legislation that would raise almost $100 billion in the 3 years from 1983 to 1985.

A small part of it, about $1.8 billion out of $100 billion resulted from new restrictions on private pension plans. These restrictions serve two purposes. One was to raise revenue. That's obvious. The other was to create a more equitable pension system by preventing excess accumulations of tax deferred compensation by high income individuals by reducing the incentives to use pension plans as a method of sheltering income from taxation and by eliminating artificial distinctions between corporate and noncorporate plans.

Some of the important provisions in TEFRA, those concerning the parity and top-heavy rules, were delayed until 1984 so the public would have an opportunity which is being granted today to present its views to this committee. Other provisions have already gone into effect. We want to get your thoughts on what the effect has been on the plans, or what you expect it to be in the future, how severe the cost of compliance with the new law has been, and what technical corrections are in order.

I think it is true that we do change things, so it's not hopeless if you have some suggestions on how improvements can be made as to what we did last year.

We have quite a list of witnesses. We are going to complete all this before lunch. We will keep pressing on until we cover all this morning's witnesses. The first witness will be Dr. Sylvester Schieber, director of research from the Employee Benefit Research Institute.

So, Dr. Schieber, come forward. We welcome you. We will get started. You have a statement?

Dr. **Schieber**. Yes, sir. A statement for the record. Senator Chafee. All right. Let's get these statements in order.

All right. Dr. Schieber, you may proceed.

STATEMENT OF DR. SYLVESTER SCHIEBER, DIRECTOR OF RESEARCH, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, D.C.

Dr. **Schieber**. Mr. Chairman, I am pleased to appear before you today to discuss the implications of the Tax Equity and Fiscal Responsibility Act of 1982. I appear in my capacity as research director of the Employee Benefit Research Institute. EBRI is a nonprofit organization dedicated to providing research and analysis which can serve as a basis for sound policy toward employee benefits.

TEFRA contains the most significant changes for employer-sponsored retirement plans since the passage of ERISA in 1974. The changes included in TEFRA will affect plans both substantively and administratively. Since parts of TEFRA have not been fully implemented, it is premature to assume that the full ramifications of this legislation are yet understood.

In my oral remarks today I intend to focus primarily on the latter two sections of my prepared testimony. Briefly, however, the first section traces the long history of expansion in the number of pension plans offered by employers, and the number of participants working under or benefiting from them. If one carefully analyzes the pattern of growth, it becomes clear that the U.S. pension system today is still relatively young. In many ways, both as a society and economy, we are only now beginning to reap the potential benefits of our employer-sponsored pension programs. Precipitous policy changes affecting these programs could thwart that potential.

The reason I come to that conclusion is that as I look back I see that the pension system has been sensitive to previous policy changes. In this regard, I point you to table 4 on page 13 of my prepared statement. It shows the plan qualifications and terminations from 1956 to September 1982.

One thing that you can clearly see is during the period 1975 to 1977, when ERISA was being implemented, that the implementation of ERISA resulted in a temporary slowdown in plan creations both in defined benefit and defined contribution plans. The implementation of ERISA also resulted rather markedly in plan terminations. Some would suggest that these were mostly bad plans. There is no evidence, however, to support that all of these were bad plans by any stretch of the imagination. In fact, many defined benefit plans were terminated to establish simpler defined contribution plans.

Some of the provisions in TEFRA may also encourage further shifting from defined benefit to defined contribution plans as resulted from the implementation of ERISA. If this is a direct policy intent, then it is not clear that there has been a full or open discussion of the desirability of such a policy goal.

The purpose of this hearing today is to assess the implications of TEFRA for various types of pension plans. To a certain extent, any assessment of the implications of TEFRA at this point in time is an exercise in the fine art of crystal ball gazing. Many of the provisions included in TEFRA have not yet been implemented. Even if there had been adjustments in anticipation of TEFRA, there is no data yet available for assessing those adjustments. This does not mean, however, that certain directional implications cannot be hypothesized. Lowering the section 415 contribution limits will reduce the pension contribution and benefits relative to salary for some highly compensated executives and professionals. If these reductions occur, some pension plans may be modified to keep pension contribution rates for middle- and lower-income workers in line with the lower rates that would result for the highly compensated.

None of the Federal agencies that regulate or monitor pension programs have ever identified and evaluated the factors that promote pension plan creations. While simple economic theory suggests that lower incentives will result in less response, it is impossible to evaluate the significance of Tax Code modifications without undertaking substantive, empirical research.

The freezing of the contribution limits for 2-years grew out of a concern that the automatic CPI indexation of social security benefits would be eliminated as part of the policies to resolve the social security financing situation. This was a matter of grave concern during the deliberations on TEFRA last summer.

There is now some concern in the pension community that the contribution limit freeze may extend beyond the 2-year period specified in TEFRA. Any extended freeze in the contribution limits will mean that the capacity of the pension programs to maintain preretirement living standards will be diminished markedly over time. The linkage of the freeze in TEFRA to the potential freeze in postentitlement indexation of social security benefits was inconsistent in the first place. What many people do not understand is that there are four elements of social security that are indexed. First, the maximum taxable income levels—the contribution limits, if you will—are indexed by wage growth each year. There has never been any discussion of freezing the social security contribution limits.

Second, a worker's earnings are indexed at retirement to account for wage growth over his or her career. These indexed wages are used to compute the initial benefit entitlement under social security.

Third, the social security benefit formula is itself indexed by indexing the bend points to account for wage growth.

Finally, the benefits themselves are indexed to account for price increases. While the ultimate social security resolution did include a 6-month delay in benefit indexation, none of the other indexing components were touched. Among private pensions and even State and local plans, full CPI indexation of postretirement benefits does not even exist today for the most part.

The reduction of the 140-percent combined contribution limit when multiple plans are offered may cause a reduction in some benefits, but it is highly unlikely that the 125-percent limit will lead to large elimination of plans. In fact, the lower limits for single plans may encourage some sponsors to set up secondary plans where they had only one in the past.

The withholding provisions have caused a lot of problems and concern among the recipient population. A good example of this is the experience the Federal Government is having with its own pension programs. The recent Federal Diary columns in the Washington Post attest to these problems. The annual notification provisions in TEFRA may make this a yearly situation.

Possibly one of the most significant implications of TEFRA is the changed perception the plan sponsors have on the way that pension policy is being made. ERISA was seen as the inevitable result of the policy process, establishing new rules to resolve problems in the pension system.

TEFRA, on the other hand, is broadly perceived as a legislative game that is being played by policy advisors who do not understand the pension system or its problems. Furthermore, TEFRA is perceived as a precursor to more changes. With the publication of the 1984 Federal budget, there is new evidence that the pension system may again become a target of the budget process.

As the budget is prepared each year a set of tax expenditures estimates is developed by the Treasury Department and published as part of the annual Federal budget. The actual estimation of tax expenditures for retirement programs is quite complicated. From a purely conceptual basis the tax expenditure estimates in this instance are flawed because the estimation procedure does not even attempt to account for significant difference in tax collections on current benefits paid and ultimate tax collections on benefits now being earned.

Senator CHAFEE. What page are you on?

Dr. SCHIEBER. Right now in the summary I am on roughly page 6.

Senator CHAFEE. But you are not following this exactly?

Dr. SCHIEBER. Not exactly.

Senator CHAFEE. Go ahead.

Dr. SCHIEBER. From a more practical policy analysis perspective, the estimates are further flawed because of the totally unexplained variations in the estimates from year to year. For example, the 1981 budget estimate of the tax expenditures for employer-sponsored retirement plans for fiscal 1981 was $14.7 billion. The 1982 budget for fiscal year 1981 placed this estimate at $23.6 billion, a 60-percent increase.

The estimated fiscal 1982 tax expenditure, due to the net exclusion of employer-pension contributions in trust fund earnings was 75.7 percent higher in the 1984 budget than in the 1983 budget. The projected growth in this category of tax expenditures for fiscal 1983 was 254.8 percent higher in the 1984 budget than in the prior year's estimate. In neither case was there any explanation or analysis of why these estimates were changed.

Through a fairly arduous process of telephone discussions with various staff at the Treasury Department we have come to discover that the primary reason for the significantly higher estimate of employer contributions and pension trust earnings in the 1984 budget is that Federal, civilian, and State and local pension plans were included in the tax expenditure calculations for the first time.

It is indicative of the relative generosity of public and private plans to consider that adding the tax expenditures attributable to public plans covering about 15 percent of the U.S. work force can increase the tax expenditures by more than two-thirds. What some might find even more intriguing is that the military retirement plan has not yet been included in any of these estimates. Nor does the current estimate take account of the fact that since the Federal, civilian retirement program is largely a pay as you go system that actual contributions bear little resemblance to benefits that are accruing under the plan.

For example, if the Federal Government had met the normal cost contribution to the Civil Service Retirement System and the military retirement program and paid one-fortieth of the unfunded liability required under ERISA for private plans that were established prior to 1974, if it had done this in fiscal 1981, the total contribution to these two plans alone would have been $89.2 billion. By comparison, the total contribution to all private plans in 1981 was $60.2 billion.

Also the tax expenditure estimates that include the contribution to IRA's have remained remarkedly stable even though the Economic Recovery Tax Act of 1981 doubled their availability by extending them for the first time to pension participants.

Many of the critics of pension programs point to these tax expenditure numbers as a basis for significant tax policy and pension reform. These critics have not applied their analytic capacities to any thorough discussion of the numbers that are published in the budget each year. They have not considered the structure of other tax code provisions that affect these estimates. They have not considered the life cycle structure of earnings, benefit accruals and marginal tax rates that provide radically different distributions of the tax expenditures than naive cross sectional analyses. They have totally ignored the inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological deficiencies in the calculation procedure.

Until the Treasury Department is willing to spell out in detail the derivation and numerical basis of these estimates, they should be treated as nothing more than idle musings or random numbers. To seriously base any policy deliberation or decision on totally unsubstantiated but clearly flawed numbers may result in the implementation of undesirable policies.

There is an impression in the pension community today, however, that these tax expenditure estimates played a central role in the consideration of TEFRA. Furthermore, the recent precipitous changes in these estimates are seen as an ominous sign that additional pension reform is high on someone's legislative agenda.

The historical response of the pension system to tax and regulatory provisions is fairly well documented. The pension system is clearly sensitive and responsive to policy change. This means that pension policy must be steady and evenhanded if the pension system is to be stable. Erratic policy or frequent adjustments will tend to destabilize existing pension programs and discourage employers from establishing new ones.

Thank you.

[The prepared statement of Dr. Schieber follows:]

PREPARED STATEMENT OF DR. SYLVESTER J. SCHIEBER, ON THE EFFECT OF PRIVATE PENSION PLANS IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Mr. Chairman, I am pleased to appear before you today to discuss the implications of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. I appear today in my capacity as Research Director of the Employee Benefit Research Institute. EBRI is a nonprofit organization dedicated to providing research and analysis which can serve as a basis for sound policy toward employee benefits. Prior to joining EBRI I served as the Deputy Director of the Office of Policy Analysis in the Social Security Administration. Prior to that I was the Deputy Research Director of the Universal Social Security Coverage Study, a study mandated by Congress. While the views that I express here are based on several years of research and analysis sponsored by various private and public organizations, they are my own and do not represent the official position of EBRI or any other organization.

TEFRA contains the most significant changes for employer-sponsored retirement plans since the passage of ERISA in 1974. The changes in TEFRA will affect both the substantive elements of plans as well as their administration. It is encouraging that the Congress is concerned about the implications of these changes on the creation and maintenance of pensions in this country today. I hope that you understand though, that it is still extremely early to expect that the full ramifications of TEFRA have yet taken effect or been measured.

My testimony today will focus on three points. The first is that the prevalence of tax incentives for pension plans, along with other factors, have contributed to the historical growth of pension protection. The second is that the pension system's growth pattern has been sensitive to changes in public policy. The third is the measurement and cost of the tax incentives provided to pension participants today. From this discussion, I hope the members of this Committee might garner a better perspective on pension policy issues in general, and the potential implications of TEFRA in particular.

THE GROWTH OF PRIVATE PENSIONS

The expansion of the role of pensions in the U.S. retirement income security system can be traced through the growth in the number of pension programs, their participants and beneficiaries. The implications of these programs on the public fisc can be traced by considering the pattern of growth of employer contributions to pension trusts and the benefits paid by these trusts.

Pension programs have been publicly regulated, in one way or another, almost since their very beginnings. Dan McGill, who has written extensively on pension programs and policy, notes that even prior the enactment of regulatory legislation, reasonable employer pension payments to retirees or contributions to trust funds were tax-deductible expenses 1/. However, the funding of prior service credits and amortization of unfunded liabilities were not tax deductible. Furthermore, income accruing to either the employer or employee in an established trust fund was taxable. The 1921 Revenue Act eliminated current taxation of income for stock bonus and profit-sharing plans established by employers to benefit "some or all" of their workers.

Through an administrative ruling, pension trusts also were accorded preferential tax treatment, and the 1926 Revenue Act established this

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1/ See Dan M. McGill, Fundamentals of Private Pension, 4th ed. (Homewood, Ill.: Richard D. Irwin, Inc. 1979), pp. 23-28, for a more detailed discussion of these developments.

treatment of pension trusts as law. The 1928 Revenue Act permitted reasonable deductions in excess of currently accruing liabilities, in effect allowing funding of past service credits. The 1928 Revenue Act allowed the continued provision of pensions for "some or all" of the employees of a sponsoring employer, which allowed owners and officers to establish plans under which they received preferential tax treatment while excluding rank-and-file workers.

Also at that time pension trusts were revocable. That is, a sponsor could establish a plan in a high-income year, make tax-free contributions to the plan, and revoke it in an unprofitable year. The 1938 Revenue Act modified the revocability provisions and required that a retirement trust be for the exclusive benefit of the employees covered until all liabilities were met under the plan.

In 1940, a sharp increase in corporate income tax rates greatly expanded the incentives to establish pension programs, particularly because the 1938 Revenue Act had not changed the provisions allowing selective coverage of the sponsor's work force. The 1942 Revenue Act and amendments to it in the 1954 Internal Revenue Code modified the tax qualification standards and changed the tax code to preclude plan sponsors from discriminating in favor of a sponsor's owners and officers.

Organized labor also played a major role in the evolution of pensions in the United States. When Inland Steel Company initiated mandatory retirement at age sixty-five in 1946, the union filed a grievance with the National Labor Relations Board (NLRB) arguing that the company's unilateral decision on this issue violated a provision in its negotiated contract dealing with separation from service. The employer argued that the mandatory retirement provision was an essential part of the company's pension program and that pensions were outside the realm of collective bargaining. The 1948 NLRB ruling, based on the 1947 Labor Relations Management Act, held that pensions were negotiable. The NLRB based its ruling on two principles: (1) that pensions fell under the term "wages" as defined in the law;, and (2) that pensions could be considered "other conditions of employment," which were negotiable. When the company appealed the ruling, the Seventh Circuit Court of Appeals found that the employer had reasonably argued that pensions were not wages but that premiums were clearly included in the "other conditions of employment" clause.

Inland Steel's original disagreement with the union over the negotiability of pensions linked to its mandatory retirement age provision indicates that employers do use their pension programs for manpower management. Over the years, the unions themselves have negotiated vigorously for pensions that help provide new jobs for younger workers as older ones retire. The Social Security Act's provision of a bottom tier of retirement income has further increased awareness that economic security for the elderly is of paramount importance. The policy focus on income .adequacy since the 1960s has especially highlighted the needs of the elderly.

Over the years, the combination of preferential tax treatment, employer and union interest and social consciousness have contributed to the growth of private pension provisions. Table 1 reflects the dramatic increase in tax qualified plans, rising from 549 at the end of 1939 to 746,000 plans as of September 30, 1982.

TABLE 1

SUMMARY OF QUALIFICATIONS AND TERMINATIONS

Period Ending	Number of Qualification Rulings to Date	Number of Terminations to Date	Net Number of Plans in Effect	Increase in Net Number of Plans Over Previous Period	% Annual Growth
Sept. 30, 1982 5/	884,936	144,963	745,973	56,693	8.2
Dec. 31, 1981	816,924	133,644	689,280	68,095	11.0
Dec. 31, 1980	741,387	120,202	626,185	56,063	9.9
Dec. 31, 1979	672,045	106,923	565,122	46,036	8.9
Dec. 31, 1978	615,168	96,084	519,086	50,398	10.8
Dec. 31, 1977	549,484	80,796	468,686	19,601	4.4
Dec. 31, 1976	514,068	64,981	449,087	3,494	0.8
Dec. 31, 1975	485,944	40,351	445,593	21,931	5.2
Dec. 31, 1974	455,905	32,243	423,662	54,781	14.8
Dec. 31, 1973	396,520	27,639	368,881	55,475	17.7
Dec. 31, 1972	336,915	23,509	313,406	45,815	17.1
Dec. 31, 1971	287,580	19,989	267,591	37,329	16.2
Dec. 31, 1970	246,916	16,654	230,262	30,268	15.1
Dec. 31, 1969	214,342	14,348	199,994	26,346	15.2
Dec. 31, 1968	186,267	12,619	173,648	22,339	14.8
Dec. 31, 1967	162,485	11,176	151,309	19,214	14.5
Dec. 31, 1966	141,964	9,869	132,095	16,973	14.7
Dec. 31, 1965	123,781	8,659	115,122	12,496	12.2
Dec. 31, 1964	110,249	7,623	102,626	10,667	11.6
Dec. 31, 1963	98,541	6,582	91,959	10,250	12.5
Dec. 31, 1962	87,397	5,688	81,709	9,359	12.0
Dec. 31, 1961	77,179	4,829	72,350	8,652	13.5
Dec. 31, 1960	67,792	4,094	63,698	9,399	17.3
Dec. 31, 1959	57,835	3,536	54,299	6,792	14.2
Dec. 31, 1958	50,569	3,062	47,507	6,551	15.9
Dec. 31, 1957	43,615	2,659	40,956	6,074	17.4
Dec. 31, 1956	37,190	2,308	34,882	4,944	16.5
Dec. 31, 1955	31,943	2,005	29,938	1,769(1)	6.3
June 30, 1955	30,046	1,877(2)	28,169(2)	3,290(2)	13.2
June 30, 1954	26,464	1,585	24,879	4,204	20.3
June 30, 1953	22,069	1,394	20,675	3,657	21.5
June 30, 1952	18,289	1,271	17,018	2,347	16.0
June 30, 1951	15,899	1,125	14,671	2,517(3)	20.7
June 30, 1950	13,899	--	--	--	--
June 30, 1949	12,865	711	12,154	896	8.0
June 30, 1948	11,742	484	11,258(4)	1,888	20.1
Aug. 31, 1946	9,370	--	9,370(4)	1,584	20.3
Dec. 31, 1944	7,786	--	7,786(4)	5,839	300.0
Sept. 1, 1942	1,947	--	1,947(4)	1,288	195.0
Dec. 31, 1939	659	--	659(4)	549	--

(1) Six month total
(2) See RR 101.-4
(3) Increase from June 30, 1949 (see RR 101.4)
(4) 28 month period, average 2,507 plans per year
(5) 9 month period, 1/1/82 - 9/30/82

*Does not include plans covering self-employed individuals (Keogh Act plans).

SOURCE: Charles D. Spencer Associates for 1930 to 1975, EBRI tabulations of IRS data for 1976 to 1982.

Historically, the growing prevalence of private pension plans has led to a marked increase in pension participation. First of all, the expansion of private pension system has been reflected by the steady growth in the number of participants and beneficiaries as shown in Table 2. Second, and perhaps more important, participation has grown more rapidly over the years than private sector employment. Private sector employment grew 15.4 percent from 1950 to 1959, 27.0 percent from 1960 to 1969 and 26.8 percent from 1970 to 1979. Over the same three periods pension participation increased by 85.7, 39.0 and 36.8 percent. Some have focused on the stabilization of the participation rate during the 1970s as an indication that the private pension system has stagnated. EBRI's previous research has identified the rapid growth in employment as the baby boom generation entered the work force, the rapid rise in female labor force participation rates during the 1970s and the implementation of ERISA as more reasonable explanations of stable pension participation rates during the 1970s. 2/

The stabilization of pension participation rates during the late 1970s was not because pension participation was not growing. It was the result of the simple mathematical calculation of participation rates where the numerator (pension participation) did not keep up with the denominator (workers) during a period in which the latter was growing at unprecedented rates. Expected private sector employment growth during the 1980s is only one-half to one-third the rate of the last half of the 1970s. Slower

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2/ Sylvester J. Schieber and Patricia M. George, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: The Employee Benefit Research Institute, 1981), pp. 23-50.

employment growth means that continued pension expansion should result in higher pension participation rates during this decade.

Even considering the stabilization of pension participation rates during the 1970s, the result of the historical growth in private pension plans is that an increasing share of the work force is participating in at least one pension program other than Social Security. The May 1979 Current Population Survey (CPS) provides the most recent available statistics on recent pension participation levels. 3/ This survey, based on a sample of households representing the U.S. civilian work force, estimated that outside agriculture, 68.3 percent of all civilian wage or salary workers between the ages of twenty-five and sixty-four, working at least half time, who had been with their employer for a year or more, were participating in a pension plan.

TABLE 2
WAGE AND SALARY WORKERS AND BENEFICIARIES PARTICIPATING IN PRIVATE SECTOR PENSION PLANS FOR SELECTED YEARS

YEAR	PARTICIPANTS IN PRIVATE PENSION PLANS		
	WORKERS (Millions)	BENEFICIARIES (Millions)	ACTIVE WORKERS PER BENEFICIARY
1950	9.8	0.5	19.6
1955	14.2	1.0	14.2
1960	18.7	1.8	10.4
1965	21.8	2.8	7.8
1970	26.1	4.7	5.6
1975	30.3	7.1	4.3
1979	35.2	9.6	3.7

Sources: Alfred M. Skolnick, "Private Pension Plans, 1950-1974, Martha Renny Yohalem, "Employee Benefit Plans, 1975." Social Security Bulletin, June 1976 and November 1977, respectively; and estimates from the May 1975 and March 1980 Current Population Survey.

3/ Ibid., p. 25.

Another indication of the growth in private pensions is the level of employer contributions, the accumulated trust funds and the level of benefit disbursements from these plans. The time series date on these pension indicators are shown in Table 3. As in the case of the number of plans and the number of participants, the aggregate pension financial data indicate a strong historical growth pattern.

There has been some concern in recent years about the distribution of the benefits provided by private sector plans. The analysis of these benefits is often based on survey data sets such as the Current Population Surveys conducted by the Census Bureau. While these surveys are extremely valuable, they are subject to limitations that warrant care in their interpretation. For example, our analysis of defined contribution pension plans has found that most of these plans are not themselves annuity plans. 4/ At withdrawal or retirement, vested participants are generally given a lump-sum distribution. in some instances, the employer will arrange for conversion of the distribution into an annuity program, but the plan itself seldom pays pension benefits in the traditional sense.

This lump-sum distribution phenomenon results in undercounting of the number of pension beneficiaries on population surveys. For example, the Census Bureau's annual March Income Supplement to their Current Population Survey gathers information on the prevalence of the receipt of pension and

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4/ Sylvester J. Schieber, Social Security: Perspectives on Preserving the System (Washington, D.C.: The Employee Benefit Research Institute, 1982) pp. 56-58.

TABLE 3

EMPLOYER CONTRIBUTIONS TO PRIVATE PENSION AND PROFIT SHARING FUNDS, PENSION FUND ASSETS AND BENEFITS PAID BY THESE PLANS FOR SELECTED YEARS

(dollar amounts in billions)

YEAR	EMPLOYER CONTRIBUTIONS	TRUST FUND ASSETS	BENEFITS PAID
1950	$ 1.7	$ 12.0	0.4
1955	3.4	27.1	0.9
1960	4.9	52.0	1.7
1965	7.6	86.5	3.5
1970	13.0	138.2	7.4
1971	15.0	152.8	8.6
1972	17.8	169.8	10.0
1973	20.7	182.6	11.2
1974	24.8	194.5	13.0
1975	27.6	210.7	14.9
1976	33.0	248.8	16.7
1977	38.4	290.2	19.7
1978	44.0	321.3	23.1
1979	48.9	424.0	27.3
1980	54.7	500.3	31.7
1981	60.2	520.2	N/A

SOURCES: Private plan contributions and benefits from U.S. Department of Commerce, The National Income and Product Accounts, 1948-1974 and Revised Estimates of the National Income Product Accounts (July 1977, and 1982); Asset totals from Federal Reserve Board of Governors Banking and Monetary Statistics, 1941-1970 and Annual Statistical Digest, various years.

the annual levels of benefits. Interviewers' instructions and training specifically direct that only regular income is to be recorded in the interview; one-time income is to be ignored. Unless defined-contribution plan lump-sum distributions are converted to an annuity, they never show up on the survey as retirement program benefits. As a result, the traditional survey estimates of pension receipt and benefit levels significantly underestimate the effectiveness of the private pension system in the delivery of benefits. For example, the March 1980 CPS provides an estimate of $18.8 billion in private pension benefits paid during 1979. The data in Table 3 from the National Income Accounts estimates private plan benefits in 1979 were $27.3 billion or more than 45 percent more than the CPS estimate.

It is partially the concern about the level of pension benefits being provided and the distribution of these benefits that leads to serious consideration of alternative tax provisions of pension programs. It is a pity that more concern is not placed on the quality of data and analysis that is available in this area. The reason that better analysis is critical is that private pensions, a vital part of the U.S. retirement system, are extremely sensitive to public policy developments.

PENSION GROWTH AND THE SENSITIVITY TO PUBLIC POLICY

The purpose of this hearing is to assess the implications of TEFRA for various types of pension plans. To a certain extent, any assessment of the implications of TEFRA at this point in time is an exercise in the fine art of crystal ball gazing. Many of the pension provisions that are included in TEFRA will not take effect until after this year. Even if there has been an anticipatory response to TEFRA, the data is not yet available for assessing that response. The IRS data on plan qualifications and terminations for the last quarter of 1982 are not yet available and TEFRA was only signed into law on September 3, 1982. This does not mean, however, that certain directional implications cannot be hypotheized. Before undertaking such an exercise, it is worthwhile to show that pension policy changes matter.

The ERISA Experience

The most significant pension legislation in the history of private plans in this country has been the Employee Retirement Income Security Act. As the earlier analysis pointed out, by the mid 1970s private pension funds held billions of dollars in assets. A few, highly publicized cases of inadquate funding, poor administration and occasional embezzlement received wide publicity. To remedy these problems and to increase pension participant and beneficiary rights, Congress enacted the 1974 Employee Retirement Income Security Act (ERISA). This legislation does not require employers to adopt employee pension programs. Where voluntary plans are established, however, they must comply with extensive reporting and fiduciary requirements and minimum standards of coverage, participation, vesting and benefit funding. ERISA also created the Pension Benefit Guaranty Corporation to ensure a level of vested benefits when defined benefit plans terminate.

Under ERISA, private employer pension plans generally must provide coverage on a nondiscriminatory basis to all employees age 25 or older with one or more years of service. Employers must also adopt a vesting schedule that satisfies one of three vesting standards. One standard requires total vesting after ten years of service. The other two require phased-in vesting after a designated period of service or a specified combination of service and age, and full vesting after fifteen years of service.

Though ERISA established extensive minimum requirements, employers continue to have considerable flexibility in determining many plan design aspects. For example, private plans can be defined contribution or defined benefit. In both instances benefit levels generally rise with increases in employee's wages and length of service. Though some private employer plans are contributory most are noncontributory. Additionally, each employer can establish an individual plan, use a preapproved master plan or join other firms in a multiemployer plan. As long as plan design features are nondiscriminatory, employers can provide more liberal coverage, participation and vesting privileges than those specified by ERISA.

While ERISA has had many ramifications for the private pension system most have not been systematically measured. One notable exception is the effect of ERISA on plan formation and termination. Based on Internal Revenue Service determination letters, Table 4 shows the annual rates of plan qualifications and terminations between 1956 and September 1982. Between 1956 and 1974 there was steady growth in newly created defined benefit and defined contribution plans. In each of these nineteen years, qualified plan establishment exceeded terminations by more than a ten-to-one ratio. Consistently, there was greater net growth in the number of defined benefit plans over the number of defined contribution plans. During 1974 the net total of defined benefit plans increased by 30,000, while defined contribution plans registered growth of 24,600 units. ERISA was signed into law on Labor Day in 1974 and was largely implemented during 1975 and 1976.

Plan creation and termination rates changed radically after ERISA. From late 1974 to early 1977, private pension programs conformed to ERISA's principal regulations. In 1973, 2,222 defined benefit plans terminated, in

TABLE 4

CORPORATE AND SELF-EMPLOYED PENSION PLAN QUALIFICATIONS TERMINATIONS AND NET PLAN INCREASES 1/

	Defined Benefit Plans			Defined Contribution Plans			
Year	Plans Qualified	Plans Terminated	Net Plans Created	Plans Qualified	Plans Terminated	Net Plans Created	Net Total Plans Created
1955							
1956	3,175	192	2,983	2,072	111	1,961	4,944
1957	3,527	180	3,347	2,898	171	2,727	6,074
1958	3,883	224	3,659	3,071	179	2,892	6,551
1959	3,824	270	3,554	3,442	204	3,238	6,792
1960	5,011	300	4,711	4,946	258	4,688	9,399
1961	4,919	374	4,545	4,468	361	4,107	8,652
1962	5,188	476	4,712	5,030	383	4,647	9,359
1963	5,840	441	5,399	5,304	453	4,851	10,250
1964	6,581	509	6,072	5,127	532	4,595	10,667
1965	7,495	512	6,983	6,037	524	5,513	12,496
1966	10,124	603	9,521	8,059	607	7,453	16,973
1967	11,292	602	10,690	9,229	705	8,524	19,214
1968	12,896	672	12,224	10,886	771	10,115	22,339
1969	14,692	969	13,824	13,383	861	12,522	25,905
1970	16,512	1,142	15,370	16,062	1,164	14,898	30,268
1971	22,493	1,605	20,888	18,171	1,730	16,441	37,329
1972	28,265	1,745	26,520	21,070	1,775	19,295	45,815
1973	33,830	2,222	31,608	25,775	1,908	23,867	55,475
1974	32,579	2,577	30,002	26,806	2,207	24,599	54,601
1975	15,319	4,550	10,769	14,720	3,558	11,162	21,931
1976	4,790	8,970	-4,180	21,030	6,775	14,255	10,075
1977	6,953	5,337	1,616	28,463	10,478	17,985	19,601
1978	9,728	4,625	5,103	55,956	10,661	45,295	50,398
1979	15,755	3,267	12,488	41,122	7,574	33,548	46,036
1980	18,849	4,297	14,552	50,493	8,982	41,511	56,063
1981	23,789	4,536	19,253	51,748	8,906	48,812	68,095
1982 1/	22,102	3,651	18,451	45,910	7,668	38,242	56,693

SOURCE: EBRI compilation of IRS data.
NOTE: This table is based on IRS plan qualification determination letters.

1/ Through September 30, 1982.

1975 this increased to 4,550 and in 1976, 8,970 defined benefit plans terminated. This pattern has continued; it significantly exceeds any projected plan termination trends suggested in the twenty years preceding ERISA's implementation. ERISA had an even greater effect on defined contribution plan terminations. In 1973, 1,908 defined contribution plans terminated, this increased to 3,558 in 1975, and 6,775 in 1976. More than 10,000 defined contribution plans were terminated in each of the next two years.

Some analysts have contended that the plan terminations that occurred after the passage of ERISA were mainly the desirable elimination of bad or financially unsound plans. Some unscrupulous sponsors and bad plans were undoubtedly weeded out by ERISA. There has never been any substantive evidence, however, that suggests that the majority of terminating plans could be so classified. In fact, the Pension Benefit Guaranty Corporation (PBGC) has found that about 40 percent of the participants in defined benefit plans terminated during the early days of ERISA were recovered by newly established defined-contribution plans. 5/ It is important to note that 18,857 defined benefit plans were terminated between 1975 and 1977, compared with 15,514 such terminations during the previous nineteen years. It is clear that ERISA resulted in a dramatic increase in plan terminations for whatever reason.

At the same time the number of plan qualifications declined markedly. The number of newly qualified defined benefit plans during 1976 was only about one-seventh the number of plans qualified only two years earlier. And

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5/ Pension Benefit Guaranty Corporation, *Analysis of Single Employer Defined Benefit Plan Termination, 1976, 1977, 1978*, 3 vols. (Washington, D.C.: PBGC 1977, 1978, 1979).

the number of newly qualified defined contribution plans in 1975 was only about one-half the prior year's level.

Table 4 shows net growth of 51,600 tax-qualified plans during the three years 1975 to 1977 compared to 54,600 plans in 1974. The average annual plan growth rates during the implementation of ERISA were less than one-third the rate for the years immediately prior to the passage of ERISA. This slow-down in pension plan growth during the mid-1970s contributed to a slower growth in pension participation rates than would have occurred otherwise.

Another facet of the ERISA experience is the notable shift toward defined contribution plans. The PBGC studies cited above indicate there was some direct shifting with defined benefit plans being terminated and replaced by defined contribution plans. Prior to the passage of ERISA, the number of newly qualified and net growth in defined benefit plans consistently exceeded qualifications and net defined contribution plan growth. If the 1973 defined benefit plan creation rate had persisted, nearly 190,000 net plans would have developed between 1975 and 1980. Actual net growth was 40,348 defined benefit plans. Based on the same criteria, however, only 144,000 defined contribution plans would have been created but actual growth was 157,175. When these figures are combined, the expected 1975-1980 private plan increase was 334,000 plans; actual increase was only 197,523 plans. Table 4 demonstrates a marked shift from defined benefit to defined contribution plans since 1976, although the desirability of this shift has not been widely discussed. Elements of TEFRA may further increase the prevalence of defined contribution over defined benefit plans. Before turning to specific aspects of TEFRA and their potential implications, a brief comparison of defined benefit and defined contribution plans is presented.

The Relative Merits of Defined Benefit and Defined Contribution Plans

Both defined contribution and defined benefit plans are organized retirement plans. Without inferring who actually bears the incidence of program costs, most of these programs in the private sector are largely supported by employer contributions. From the employee's perspective either type of plan helps provide income security in retirement. From the employer's perspective either helps in the orderly recruiting, maintenance and retirement of the necessary workforce.

The defined benefit plan provides a clearly stated retirement income level generally related to years of service and a measure of salary toward the end of employment tenure. The defined contribution plan, on the other hand, provides for specified contribtuions to an individually allocated investment account. Without comparing the actual level of benefits provided to specific individuals under one plan or the other, the two types of plans can be compared from an equity perspective. In this regard Trowbridge argues:

> That the employer contributes the same percentage of pay for every covered employee is a philosophical strength of the defined contribution arrangement. The underlying principle of equity is that individual workers enjoy benefits of equal value.
>
> In defined benefit pension plans, as in most group insurance arrangements, the principal is one of equal benefits. Equal benefits are rarely the same as benefits of equal value, because employees vary as to age, sex, and other risk characteristics.
>
> In summary, defined contribution plans define individual equity in terms of equal employer contributions and accept the necessarily unequal benefits that equal contributions provide. Defined benefit plans define equity in terms of equal benefits and accept the necessarily unequal employer contributions. 6/

6/ Charles L. Trowbridge, "Defined Benefit and Defined Contribution Plans: An Overview," in Economic Survival in Retirement: Which Pension Is for You? (Washington, D.C.: The Employee Benefit Research Institute, 1982), pp. 3-34.

In addition to these equity differences that apply under the ceteris paribus conditions, there are other differences in the two approaches to pension provision that arise because other things are not always equal. These arise partly because of the inherent differences in the two types of plans, but also because of tradition and the differential treatment of the plan types under the tax and regulatory code.

The relative desirability of a defined benefit versus a defined contribution plan depends a great deal on the goals the plan is supposed to meet. If everyone's goals coincided, then an ultimate plan design could be arrived at easily. There are always several players concerned about the design of a retirement plan who do not have coincidental goals.

Defined benefit (DB) plan are often preferred because they can provide retrospective credits whereas defined contribution (DC) plans are prospective. This is especially the case at the time the plan is established if there are workers with several years of tenure who will be covered by the new plan. This ability to grant past service credits is particularly attractive where an employer is offering a pension for the first time. This may not be important if the employer has a plan and is considering a new one but may be important if current workers are given the option and encouraged to transfer to the new program. It is also important in the case of benefit enhancements. Under DB plans such enhancement can be granted on the basis of prior service. With a DC plan this is far more complicated, if not practically impossible.

An important reason that it is difficult to provide such retroactive protection under a DC plan is that employers do not typically keep lifetime historical earnings records on which such a benefit increase would be based. The most important reason, however, is because of the different funding procedures used in the two approaches. The DC plan by nature is always fully funded. To grant retroactive credits under such a plan could require a crushing contribution to fund such benefits. The DB plan, on the other hand, would allow the creation of an unfunded liability that could be amortized over several years. While it is impossible to project the likelihood of future benefit enhancements at the inception of any new pension plan, private defined benefit plans have a long history of gradual benefit improvements, often retroactively.

The differences in funding provisions and the tax code may provide the employer the incentive to provide more generous benefits under a defined benefit than a defined contribution plan. This occurs because the defined contribution credits have to be funded in the period in which they occur, whereas the defined benefit accruals can be funded at a later point in time. This offers the plan sponsor the opportunity to fund the plan to a greater extent during profitable periods and to delay contributions during leaner times. It is partly this difference in funding requirements that makes profit sharing plans the predominant type of defined contribution program.

Another difference between DB and DC plans is that they are structurally different. This is important because it affects the participants' understanding and attitudes toward the plan. In the DB plan the participants can be educated to understand that their benefits will replace a closely estimated percentage of their final earnings and that the pension in combination with Social Security will maintain an estimable portion of the preretirement standard of living. The DC plan provides a clearly perceptible growing account balance. A problem that many workers have is in comparing the relative values of the two types of plans. The defined benefit is stated in flow terms while the defined contribution is a stock.

The stock and flow differentials in the two plan types can be easily reconciled by actuaries and economists. For the individual worker the stock concept may be more easily understood during the period of accumulation, but it is the flow of income that is important in retirement. A person's standard of living is largely determined by the flow of goods and services they can consume over time. While the defined contribution accumulation can be converted to an annuity at retirement most workers cannot readily estimate the extent to which their preretirement earnings will be replaced until the end of their career. In part, this is the result of the arithmetic involved in converting stocks to flows. It is also the result of uncertain projections of the stock values which themselves are subject to inflationary and market forces that are not always understood.

The latter point relates to a third difference between DB and DC plans. In the defined contribution plan, investment performance directly affects the level of benefits. Because contributions and interest accruals relate to specific persons, the risk of adverse market performance is borne by the individual worker. Under the defined benefit plan, on the other hand, the individual is promised a level of benefits related to final salary. Adverse market performance can reduce the value of the pension portfolio as in the case of the DC plan. However, the employer has guaranteed the benefit and has to adjust contributions to make up for bad investment performance.

There are also traditional differences between DB and DC plans that have evolved because they are perceived differently by workers. The perceived accrual of a capital stock in the defined contribution plan raises the employee's consciousness of the value of accumulating assets. The accumulated value of the asset is also much more portable than a vested defined benefit promise. The individually assigned assets can be liquidated and reinvested in an individual retirement account, making them highly portable. This combined perception of a definable asset, along with relative portability may combine to account for typically shorter vesting in DC plans. For the highly mobile worker, the defined contribution plan may be preferred because of its portability characteristics. For the long-term stable employee, on the other hand, the primary concern is likely to be an adequate level of benefits to maintain preretirement earnings standards. This will more likely be assured through a defined benefit plan. Most defined contribution plans do not have automatic provisons to convert the accumulated assets to an annuity at retirement. The more typical cash-out provisions in these plans are often criticized because it is feared the accumulated funds are often not used for retirement income security purposes. There is virtually no extant data that allows analysts to evaluate the actual utilization of asset accumulations in defined contribution plans. The May 1983 Current Population Survey being conducted by the Census Bureau and jointly sponsored by EBRI and the Department of Health and Human Services will gather such information for the first time. The survey will elicit information on the prevalence and level of lump sum distributions from retirement plans and the disposal of these assets.

The questions posed by the different benefit structures inherent in defined benefit and defined contribution plans give all parties concerned about federal retirement policy much to ponder. Neither the defined benefit nor the defined contribution structure is perfect to meet everyone's goals. It is the conflicting goals of different workers, employee groups, employer and public policy goals that makes it impossible to select one type of plan over the other as being ideal. But everyone should understand that there are good reasons for and against both plan types. That, more than any other reason, may account for the fact that most large employers in the United States today have both a defined benefit and defined contribution plan for their workers.

The Potential Implications of TEFRA

The impact of TEFRA on the U.S. private pension system will vary across various segments of the employer and plan universe. The variations will arise on the basis of plan size, the number of plans offered by the plan sponsor and the characteristics of the workforce covered by a plan.

Among the various TEFRA provisions that may affect the creation and maintenance of pensions are the changes to tax deductible contribution limits. The Section 415 dollar limitations on annual benefits payable under a defined benefit plan were reduced from $136,425 to $90,000. Similarly, the dollar contributions under a defined contribution plan are reduced from $45,475 to $30,000. These limits are to be frozen until 1986 when they will be allowed to rise in accordance with Social Security COLA adjustments.

For participants covered by both a defined benefit and defined contribution plan, the Section 415 contribution limits affecting multiple plans were also reduced. Under pre-TEFRA provisions a plan sponsor with multiple plans who had contributed the maximum under one contribution limitation could not make a tax deductible contribution of more than 40 percent of the other contribution limitation to the second plan. This 140 percent or 1.4 limit was reduced to 1.25 by TEFRA.

TEFRA further adjusted the Section 415 limits for defined benefit plans where benefits commence prior to age 62. Under TEFRA the defined benefit that can be funded is actuarially reduced to $75,000 for retirement at age 55. TEFRA also allows for incremental adjustments to benefits that are taken after age 65.

Lowering Section 415 contribution limits will reduce pension contributions and benefits relative to salary for some highly compensated executives and professionals. If these reductions occur, some pension plans may be modified to keep pension contribution rates for middle- and low-income workers in line with the lower rates that would result for the highly compensated. None of the federal agencies that regulate or monitor pension programs have ever identified and evaluated the factors that promote pension plan creations. While simple economic theory suggests that lower incentives will result in less response, it is impossible to evaluate the significance of tax code modifications without undertaking substantive empirical research.

In recent years, private pension contribution limits have been indexed with the CPI. This indexing provision permits pension benefit financing for each new wave of retirees, which replaces roughly the same proportion of preretirement earnings as received by earlier groups of retirees. The indexing of maximum taxable income and the benefit formula bend points for Social Security accomplishes essentially the same result. There is some question whether the CPI is an appropriate basis for indexing pension contribution limits. Because pensions are wage-related programs, some argue that wage indexation would be more appropriate. In any event, freezing contribution limits will reduce the income replacement capacity of pension programs over time. The TEFRA freeze would affect a small number of current pension participants. As the general level of wages rises, however, the portion of the work force affected would increase if the TEFRA freeze is extended. As more people reach the limits, the income replacement capacity of pensions would diminish. This, combined with Social Security's redistributive nature means an ever increasing share of the elderly would be unable to maintain preretirement living standards through benefits from organized retirement programs.

Social Security contribution limits are indexed. So are earnings in the benefit formula for purposes of determining benefit levels. Benefits are indexed to keep up with inflation after retirement. There is no simple comparison to be made between private pension contribution limits and the various indexed components of Social Security. Pension programs do not directly provide for any of the kinds of indexation inherent in Social Security. Most pension benefits bear a fairly direct relationship with earnings received at the end of a receipient's career. This indicates that private pension contribution growth has roughly approximated the combined effects of Social Security's earnings and benefit formula indexation. Beyond this, few private or public retirement programs, other than federal programs, now provide full CPI indexation of postretirement benefits.

To the extent that an employer has a single plan and will be affected by the contribution limit reductions or freezes, there will now be added incentive to establish a secondary plan to take advantage of the combined contribution limitations. The reduction of the Section 415 limits for multiple plans may also encourage the reduction of some existing plans, however.

It is easy to make a case that some high-income workeres are receiving substantial tax deferrals under pre-TEFRA rules. Clearly, anyone now benefitting from the .4 supplemental limit will have this preferential tax treatment of their contributions to secondary plans reduced. The important issue, however, is whether secondary plans will be terminated when this measure is implemented. If secondary plans will be terminated, then policymakers must ask whether the added tax revenues are worth reducing private pension benefits not only to high-income plan workers, but to rank and file workers as well.

Little empirical evidence exists about where or why secondary plans are established. Some believe they are set up primarily by small professional service corporations so high-income professionals can avoid taxes. A countervailing opinioin holds that they are established as the private sector's answer to postretirement benefit indexation. Private plan sponsors cannot fully underwrite unanticipated inflation in their defined benefit pension programs. Secondary plans, therefore, provide pension beneficiaries with a second line of defense against the insidious effects of inflation on retirement income.

While there is no information on the number of secondary plans being created, if these plans are established primarily to shield the income of incorporated professionals, newly established plans would include relatively few participants. According to IRS data, on all plan creations in 1979, 57,000 newly tax qualified plans had an average of thirty-six participants; in 1980, 69,000 newly qualified plans averaged fifty-five participants; and in 1981, roughly 82,500 new plans averaged forty-three participants. While some individuals or small professional groups may have incorporated to take advantage of existing Section 415 limits, many new pension plans are including significant numbers of workers. Imposing new limits, therefore, may hit a broad target -- not just a few high-income professionals.

Given that the 1.4 limits were reduced to 1.25 and not completely eliminated the likelihood that many plans will be terminated is probably slight. The complete elimination of the tax incentive to set up secondary plans, on the other hand, would make them less desirable for many plan sponsors. Any individual who is benefitting from the maximum contribution limits under this provision of the bill will almost certainly be in a high marginal tax bracket during their retirement years. The benefits provided to such individuals by this section of the tax code represent almost completely a tax deferral and not a tax expenditure as discussed later in this testimony. To chance elimination of plans beneficial to lower and middle-income workers to reduce the tax deferrals available to a small number of high-income taxpayers may not be a wise policy option to pursue further.

Withholding Provisions - TEFRA has extended to the "payor" or the plan administrator of pension and deferred compensation plans the obligation of tax withholding on pensions, annuities and deferred compensation payments. The Act allows the individual recipient to elect-out of withholding. At least once a year the payor has to notify the beneficiary of his or her right to change their status.

This provision is one of those that makes sense in concept but can result in various calamities in actual operation. When plan sponsors warned of potential problems during the TEFRA deliberations their concerns were largely unheard. The Washington Post recently ran an interesting story in this regard on the Federal Government's experience with its own annuitants.

> The OPM says that many retirees apparently didn't undestand the new withholding system. Some, OPM says, put down the amount they wanted deducted for the entire year. But that amount is being taken out each month, and will be until the retiree "corrects" it.
>
> Others, OPM said yesterday, put down a dollar amount to be withheld monthly, unaware that that amount would be added to the amount to be deducted based on the number of exemptions they claim.
>
> Members of Congress from the Washington area have been inundated with calls from angry, frustrated retirees. The National Association of Retired Federal Employees says it has been hearing from retirees all over the country, who are wondering what happended to their annuity checks. 7/

If these problems arise among other plans and persist beyond the start up period, Congress may want to reconsider certain of the provisions in this section of the Act.

Social Security Integration - For defined contribution plans TEFRA does not allow the contribution rate below the Social Security taxable income maximum to be more than the OASDI tax rate below the contribution rate above that income tax level. Prior to TEFRA, the differential

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7/ Mike Causey "Uncle's Double Whammy on Retirees' Checks," The Washington Post (Wednesday April 6, 1983), p. c2.

contribution rate above and below the taxable maximum was 7 percent. The TEFRA provision was aimed at reducing the extent of Social Security integration in profit sharing and other defined contribution plans.

The early indications are that many plans will be modified to reduce the contribution rates on incomes in excess of the Social Security taxable maximum. This provision does not seem to recognize the substantial redistributive characteristics of Social Security. Nor does it recognize the low rates of return that individuals will receive on their combined employer-employee payroll tax if they are at or above the taxable income maximum and expect to retire after the mid 1990s. The differential contribution rates of 1.3 percent in 1984 between pre or post-TEFRA provisions or .8 percent beyond 1990 would not completely offset the redistributive capacity of Social Security or ameliorate its poor rate of return provisions for workers who would benefit.

Top-Heavy Plan Provisions - For plans that primarily benefit key employees there are special provisions in TEFRA. First TEFRA provides for three-year cliff or six-year graded vesting. Second, there are minimum benefit or contribution provisions for non-key employees. Third, there is a limitation of $200,000 of any employees salary that can be considered for purposes of making plan contributions. Fourth, top heavy plans have special Section 415 limits when multiple plans are offered. Finally, distributions to key employees prior to age 59 1/2 are subject to a special 10 percent tax. Also distributions to key employees have to begin by age 70 1/2.

The top-heavy provisions are complicated in several regards, not the least of which is the determination of top heavy status. It is clear that these provisions will effect primarily smaller employers. To the extent that the provisions are complicated and may require special administration expense they may discourage pension plan creation by some smaller firms. To the extent the firms stay small, not much pension coverage will be foregone. If the firms expand, the delay in establishing a plan can mean substantial losses in ultimate retirement security for significant numbers of workers.

One particular problem with top heavy provisions could be the potential for firms to wander in and out of top-heavy status. It is certain that some firms that are not top heavy could be driven into such status by conditions beyond their control (e.g., layoffs during a recessionary period).

According to some pension consultants as many as 30 to 40 percent of small plans may be terminated. Others expect that large numbers of defined benefit plans may be terminated and replaced with defined contribution plans.8/ If this is the desirable outcome of public pension policy it has never been openly discussed in the Congressional forum.

Self-Employed and Personal Service Corporation Plans - The provisions of TEFRA have eliminated the disparities between the tax treatment of plans established by the self employed and those set up by individuals who have incorporated in the past to take advantage of corporate pension tax provisions. These provisions may result in the disbanding of some personal service corporations. The higher contributions limits now available to the self employed may encourage more rapid expansion of Keogh plans.

8/ Diane Hal Grupper, "The Furor Over TEFRA," Institutional Investor (February, 1983), pp. 71-80.

THE LESSONS FROM ERISA AND TEFRA

The private pension system today is in turmoil. In large measure the plan creation data of the last two to three years indicated that it had recovered from the initial shock of ERISA. The economics of high inflation during the latter 1970s and the extended recession of the early 1980s have caused problems that have been largely handled. The shock of TEFRA is being applied to a system that has been buffetted for most of the last ten years. The system has been extremely resilient until now and may survive TEFRA relatively unscathed. Then again, it may not.

Just because a policy shift might result in significant adjustments in the pension system does not mean that it should be judged bad policy, however. It is clear that ERISA has provided some positive reforms; it has also created some problems. One stark difference in the evolution of ERISA and TEFRA was the time and deliberation that went into their development.

ERISA evolved through careful and extensive discussions between most of the major parties interested in a healthy pension system. TEFRA evolved quickly in an environment of overwhelming budget deficits when pension reform was considered in the context of closing tax loopholes for the rich. It was understood that ERISA would result in some plan terminations, but that was accepted because those plans were believed to be unstable anyway. It was thought that TEFRA might result in some plan terminations also, but mainly those offered by unscrupulous sponsors out to beat the spirit of the tax provisions favoring pensions.

Among plan sponsors ERISA was seen as the inevitable result of the policy process establishing new rules to resolve problems in the pension game. TEFRA, on the other hand is broadly perceived as a legislative game being played by policy advisors who do not understand the pension system or its problems. Furthermore, TEFRA is perceived as a precursor to more changes. With the publication of the 1984 federal budget there is new evidence that the pension system may again become a target of the budget process.

THE EFFECT OF PENSIONS ON THE BUDGET

During the last two years there have been significant changes in federal tax laws affecting employer sponsored and individually established retirement programs. The Economic Recovery Tax Act (ERTA) of 1981 expanded the availability of Individual Retirement Accounts (IRAs) to include workers already covered by a pension plan. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 reduced tax exempt contribution limits for private plans.

These and earlier provisions of the U.S. Tax Code have been the subject of much discussion and debate in recent years. The dialogue has often centered on the impact that favorable tax provisions allowed pensions and individual retirement programs have on federal tax collections. Some policy analysts believe that current provisions in the tax law favoring retirement programs are unwarranted.

The discussions of these issues are bound to take on a sense of heightened proportions in the coming year for two reasons. The first is that the Federal Budget continues to be plagued by unprecedented deficits meaning that all favorable tax provisions will come under closer scrutiny. The second is that the Treasury Department has recently increased its estimate of "tax expenditures" for employer-sponsored retirement plans by 75 to 80 percent. Virtually no explanation has been provided for this precipitous increase.

Conceptual Background on Retirement Program Tax Expenditures

As the Budget of the United States Government is prepared each year a set of "tax expenditure" estimates is developed by the Treasury Department and published as part of the Budget. The "tax expenditure" concept was first laid out in 1967 by Stanley S. Surrey, the Deputy Assistant Secretary for Tax Policy at Treasury from 1961 to 1969. He stated:

> Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures -- in effect to produce an expenditure system described in tax language.
>
> When Congressional talk and public opinion turn to reduction and control of Federal expenditures, these tax expenditures are never mentioned. Yet it is clear that if these tax amounts were treated as line items on the expenditure side of the Budget, they would automatically come under close scrutiny of the Congress and the Budget Bureau. 9/

The Congressional Budget Act of 1974 (P.L. 93-344) formally institutionalized "tax expenditures" as part of the regular Budget document. The act defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 10/ Within this context, tax expenditures are defined as "exceptions to the normal structure" of individual and corporate tax rates.

9/ Stanley S. Surrey in a speech to Money Marketeers, New York City, November 15, 1967.

10/ Special Analyses Budget of the United States Government Fiscal Year, 1981 (Washington, D.C.: Office of Management and Budget, 1980) p. 207.

A problem with the concept of tax expenditures is that the tax code does not include a definition of the "normal structure" of the tax system. As the 1983 Budget points out, the term itself is "unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to 'special' tax provisions represent Government 'expenditures,' why not consider all tax rates below 100% 'special,' in which case all resources are effectively Government-controlled?" 11/ As a result the practical definitions that have arisen in the measurement of annual tax expenditures are not always consistent within or across categories, or from year to year.

An example of this is the Department of Treasury's estimates of the revenue losses or tax expenditures that can be attributed to the favorable tax provisions afforded pensions and individual retirement accounts. In this case the Treasury estimates the federal tax revenue losses that arise because neither pension and IRA contributions nor the fund earnings are taxed until benefits are paid. The theoretical basis for these estimates is that if employer contributions to pension trusts or individual contributions to IRAs were taken as regular income that additional tax obligations would arise at the time the contribution is made. The amount of the tax expenditure, however, is not simply current reductions on tax revenues but recognizes that there will be future tax collections at the point of distribution and thus represents taxes deferred, not taxes foregone.

11/ Special Analyses Budget of the United States Government Fiscal Year, 1983 (Washington, D.C.: Office of Management and Budget, 1982) p. 3.

It is really differential marginal tax rates over time that give rise to the estimated tax expenditures. For example, consider a simple case where a person's life is made up of only two periods. During the first period the person works, earns income and pays income taxes. Assume that this person's employer establishes a pension plan during the first period and makes a $1000 contribution in behalf of the worker. Assume further that this contribution would have been paid to the worker as wages if it had not been contributed to the pension plan. Furthermore, for simplicity, assume the worker's marginal tax rate is 50 percent. That is, for each additional dollar of earnings the worker's tax liability would increase by 50 cents. Finally, assume that the time price of money or rate of return between the two time periods is 10 percent.

If the employer contribution to the worker's pension account is not taxed during the first period then the government foregoes $500 in tax revenue. (.50 X $1,000) during the period. At the beginning of period 2, assume that the worker retires and is eligible to receive the $1,000 plus $100 in interest accrued on the fund since its investment. If the person is still in the 50 percent tax bracket the tax liability on this retirement income will be $550. Given the time price of money, this is equivalent to the tax liability if the pension has been taxed at the point of contribution and if the taxes collected had drawn interest until period 2. In this instance the person does not avoid any taxes by participating in the pension plan; the taxes are merely deferred from the first period to the second. There is no tax expenditure in this case.

If it is assumed, however, that the marginal tax rate in the second period is lower than that in the first then the result is quite different. Assume that in the second period that the person's marginal tax rate drops to

30 percent, then the contribution in period 1 results in reduced tax revenues of $500. When the contribution plus interest is taxed in period 2 it nets only $330 in tax revenues. Discounting the period 2 taxes back to period 1 to account for the time price of money means that the value of taxes to be collected on the contribution will only be $300. Since $500 is foregone in the current period and the future taxes are only worth $300, the cost to the public fisc, or the tax expenditure, is $200.

Methodological Problems in Estimating Retirement Program Tax Expenditures

The world is not quite as neat as this simple example, however, and thus, the actual estimation of tax expenditures for retirement programs is quite complicated. First, Treasury estimates the foregone taxes from exempting employer pension contributions and personal IRA contributions and the interest paid to these funds. From this foregone collections estimate Treasury subtracts the estimated tax collections on pension benefits paid. The net difference is their estimated tax expenditure resulting from the tax treatment of retirement programs.

From a purely conceptual basis the tax expenditure estimates in this instance are flawed because the estimation procedure does not even attempt to account for the significant difference in tax collections on current benefits paid and the time discounted value of future tax collections based on current contributions under these plans. From a more practical policy analysis perspective, the estimates are further flawed because of the totally unexplained variations in estimates from year to year. Each of these problems is discussed in more detail below.

In the simple single-worker, two-period example used above it was possible to show how the tax expenditures in question arise. The tax expenditure that arose in that case was the difference in the value of the person's lifetime tax obligations that resulted because part of earnings could be deferred as a pension contribution. In the actual estimates of tax expenditures for retirement program the foregone revenues are estimated on the basis of one set of individuals and the tax collections on pension benefits are estimated on a totally different set of individuals. This procedure would upwardly bias the estimated tax expenditure for two reasons.

The first is that current workers will have higher real earnings levels over their lifetime than current beneficiaries. It is this phenomenon that raises the real level of Social Security and pension benefits alike for succeeding cohorts of retirees. As a result, the marginal tax rates that will be paid on pension benefits earned today will be higher than the marginal tax rates on benefeits that are paid today. Underestimating the marginal tax rates that will apply to currently earned benefits will overestimate the magnitude of tax expenditures.

The second reason that current estimation techniques result in biased estimates of retirement program tax expenditures is that the pension system in this country is not yet mature. For example, consider the case of a brand new pension plan in a firm with middle age and younger workers. For several years the employer will make contribuitons, representing foregone tax collections in the calculation, but no benefits will be paid, and thus, there are no offsetting tax revenues collected that enter the tax expenditure calculation. If the expenditure was estimated by subtracting future discounted taxes on pensions from foregone taxes on current trust fund contributions and interest it would make no difference if there were beneficiaries or not. The maturity of the pension systems would not be important if the tax expenditures were estimated as in the hypothetical example, but is critically important given the actual method of calculation.

Table 5, based on tabulations of information that plan sponsors filed with the IRS (form 5500) in compliance with ERISA for the 1977 plan year, indicates a clear relationhsip between plan age and beneficiaries in defined-benefit plans. Defined benefit plans cover two-thirds of private plan participants and an even larger segment of the public plan members. Among other things, form 5500 requires reporting the "effective plan date" or date the plan was set up. It also requires the number of active participants in the plan, and the number of beneficiaries be reported. The age of the plan can be calculated from the effective plan date. As expected, most of the young plans have more workers per participant than older plans do. Less than 10 percent of the plans that had been created in the previous five years reported fewer than five workers per retired beneficiary. For plans operating twenty-five years or longer, nearly 49 percent had fewer than five active participants per beneficiary. The changes in this relationship with increasing plan age are too consistent to be coincidental. At the other end of the participant/beneficiary range, the pattern is comparably consistent. More than 55 percent of plans less than five years old had twenty or more active workers per beneficiary, while less than 11 percent of the oldest plans reporting had as many as twenty participants per beneficiary.

Undoubtedly many of the older plans with high participant/beneficiary ratios are in firms that are expanding. High participant/beneficiary ratios will contiue as some plan sponsors continue to expand in the future, but such sponsors will still have increasing numbers of beneficiaries over the years.

This relationship of plan age and beneficiary rates becomes particularly significant in comparison with defined-benefit plan creation data. 12/ Using 1977 as the reference year, because it corresponds with the ERISA data, the universe of private defined-benefit programs grew by 218,487 plans in the previous twenty years; 32.0 percent of this growth occurred between 1973 and 1977 and 72.7 percent between 1968 and 1977. If all 28,169 tax qualified plans in existence at the end of 1955 were assumed to be defined-benefit plans, which is certainly not the case, 62.7 percent of all defined-benefit plans would have been less than ten years old at the end of 1977. The defined-benefit pension system in this country today is still quite young. As the system matures, the ratio of workers to beneficiaries will markedly decline, much as the ratio of workers to beneficiaries in the Social Security program declined during the 1950s and 1960s. The ratio will decline not because of fewer covered workers, but because of more beneficiaries. The relatively small number of beneficiaries today, however, results in significant overestimates of retirement program tax expenditures.

This bias in the tax expenditure estimates will decline, to some extent, as programs mature but can never be totally resolved because of the wage growth phenomenon cited earlier.

Unexplained Variations in the Estimates

One of the problems with the estimates of tax expenditures arising from the special tax provisions for retirement programs is precipitous changes in the estimates from year to year that are not explained. As an example of this

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12/ These data are spelled out in detail in Sylvester J. Schieber, *Social Security: Perspectives on Preerving the System* (Washington, D.C.: The Employee Benefit Research Institute, 1982) p. 52.

TABLE 5

WORKING PARTICIPANTS PER BENEFICIARY IN DEFINED BENEFIT PENSION PLANS WITH MORE THAN 100 ACTIVE PARTICIPANTS DURING 1977 BY PLAN AGE

		Plan Age						
	Total	Less Than 5 Years	5-10 Years	11-15 Years	16-20 Years	21-25 Years	Over 25 Years	Unknown
Total Plans (number)	22,467	4,092	5,418	3,839	3,008	2,258	3,628	224
Working Participants Per Beneficiary		Percentage of Plans						
Two or less	5.5	1.9	2.1	3.4	7.0	10.5	12.0	7.6
More than 2, up to 5	19.8	7.5	10.2	17.2	27.9	31.3	36.9	21.9
More than 5, up to 10	20.1	10.7	17.4	23.5	25.9	24.9	23.1	21.9
More than 10, up to 20	15.4	13.1	19.6	19.3	15.7	12.1	9.4	12.5
More than 20	30.0	55.5	39.7	26.7	16.9	14.4	10.8	26.3
Unknown a/	9.3	11.3	10.9	9.9	6.7	6.7	7.7	9.8

SOURCE: EBRI tabulations of 1977 plan disclosure data submitted to IRS in compliance with ERISA.

a/ Includes plans with no beneficiaries reports.

TABLE 6

FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS PRESENTED IN SELECTED FEDERAL BUDGETS

Budget	FISCAL YEAR				
	1980	1981	1982 (in millions)	1983	1984
1981 Budget	$ 12,925	$ 14,740			
1982 Budget	19,785	23,605	$ 27,905		
1983 Budget		23,390	25,765	$ 27,500	
1984 Budget			45,280	49,700	$ 56,560

SOURCES: Special Analysis G of the Budget of the United States Government for Fiscal Years 1981-1984 (Washington, D.C.: Office of Management and Budget).

inconsistency Table 6 shows the tax expenditure estimates due to the tax treatment of employer sponsored plans included in the last four Federal Budgets.

The 1981 Budget estimate of this particular tax expenditure for fiscal year 1981 was $14.7 billion. The 1982 Budget estimated the 1981 fiscal year tax expenditure for the identical category of plans at $23.6 billion -- a 60 percent increase. There was absolutely no explanation in the Budget documents explaining the changed estimate from one budget to the next. The only explanation that we have found for the 1980 and 1981 Budget differences is by Munnell who writes that the "Revised estimates employ higher, and therefore move realistic, marginal tax rate assumptions. These indicate a substantially larger tax expenditure for private plans." 13/ The explanation that higher marginal rates were used to generate the 1982 Budget estimates is plausible. What is interesting is that there is absolutely no published documentation on

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13/ Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Instituteion, 1982) p. 44.

the actual rates used to generate either the 1981 or 1982 Budget estimates. Not only does Munnell ignore this completely throughout her book on private pensions but she also fails to explain her conclusion that the higher tax rate assumptions used in the 1982 Budget estimate are "therefore more realistic." There is certainly no a priori reason to believe that any set of assumptions in more realistic than another without an analytical basis on which to evaluate them. Such analysis was not available to compare the 1981 and 1982 Budgets. There is also a lack of analysis explaining even greater discrepancies between the 1983 and 1984 Budgets. The estimated fiscal 1982 tax expenditure due to net exclusion of employer pension contributions and trust fund earnings was 75.7 percent higher in the 1984 Budget than in the 1983 Budget. The projected growth in this category of tax expenditure was 254.8 percent higher in the 1984 Budget than in the prior year's estimate. Again, none of the Budget materials or other public documents explain the revised estimates.

Through an arduous process of telephone discussions with various staff at the Treasury Department a general explanation of the revised fiscal 1983 and 1984 estimates in the 1984 Budget has been pieced together. One reason for the difference in the two Budgets is that the analyst who did the 1983 Budget estimates retired and a new analyst prepared the 1984 Budget estimate. The new analyst has been able to partially clarify the discrepancy. The difference in the estimates for fiscal 1982 is $19.515 billion (i.e., $45.280 - $25.765). Of this $17.135 billion is attributable to higher estimated contributions and pension trust earnings. The remaining $2.380 billion in the higher tax expenditure estimate from the 1984 Budget is attributable to changes in the tax rate assumptions.

It appears the the primary reason for the significantly (some would say astronomically) higher estimate of employer contributions and pension trust earnings is that federal civilian and state and local pension plans were included in the tax expenditure calculations for the first time. It is indicative of the relative generosity of public and private plans to consider that adding the tax expenditures attributable to public plans covering about 15 percent of the U.S. workforce can increase the tax expenditure estimate by more than two thirds. This element of the revised tax expenditure estimate can be better understood by looking at recent annual contributions to pension trusts in the various sectors.

Table 7 includes recent annual contributions to privately sponsored retirement programs, state and local plans and the federal Civil Service Retirement System. While the latter does not include all federal civilian pension costs it does capture at least 90 percent of these costs and is sufficient for this comparative analysis. What is immediately apparent is that adding in the public employer plan contributions increases the basic private employer contribution in 1981 by 63.5 percent (i.e., $38.26/$60.26). As stated above the 1983 Budget estimate of retirement plan related to tax expenditures in 1982 was $25.8 billion. The 1984 Budget tax expenditure estimate was $17.1 billion (or 66.3 percent) higher because of added trust fund contributions and interest income considered. It appears that virtually all of this adjustment can be laid directly to the inclusion of the public plans for the first time.

The remaining $2.4 billion discrepency in the 1983 and 1984 Budget estimates of retirement program tax expenditures for 1982 was attributed to changes in the tax rate assumptions. At first blush one might think that the effects of the Economic Recovery Tax Act of 1981 would be to reduce the tax

TABLE 7

EMPLOYER CONTRIBUTIONS TO RETIREMENT PROGRAMS FOR SELECTED PRIVATE AND PUBLIC EMPLOYER PLANS

Year	Private Pension and Profit Sharing Contributions (billions)	Private Pension and Profit Sharing Contributions (Percent) (of total)	State and Local Contributions (billions)	State and Local Contributions (Percent) (of total)	Federal Civil Service Retirement Contributions (billions)	Federal Civil Service Retirement Contributions (Percent) (of total)	Aggregate Employer Contributions (billions)
1970	$ 13.0	66.3%	$ 4.6	23.5%	$ 2.0	10.2%	$ 19.6
1971	15.0	65.5	5.2	22.7	2.7	11.8	22.9
1972	17.8	66.2	5.8	21.6	3.3	12.3	26.9
1973	20.7	66.3	6.6	21.2	3.9	12.5	31.2
1974	24.2	65.8	7.8	21.2	4.8	13.0	36.8
1975	27.6	63.6	9.1	21.0	6.7	15.4	43.4
1976	33.0	64.0	10.7	20.7	7.9	15.3	51.6
1977	38.4	63.9	12.4	20.6	9.3	15.5	60.1
1978	44.0	64.0	13.7	19.9	11.0	16.0	68.7
1979	48.9	63.5	15.3	19.9	12.8	16.6	77.0
1980	54.7	62.3	17.5	19.9	15.6	17.8	87.8
1981	60.2	61.2	20.0	20.3	18.2	18.5	98.4

SOURCES: Private Plan contributions from U.S. Department of Commerce, The National Income and Product Accounts, 1948-1974 and Revised Estimates of the National Income Product Accounts (July 1982); State and Local Government plan contributions from U.S. Bureau of the Census, Finances of Employee Retirement Systems of State and Local Governments, 1970-1971; 1972-1973; 1973-1974; 1975-1976; 1976-1977; 1977-1978; 1978-1979; 1979-1980; 1980-1981. Table 2; Federal Civil Service Plan Contributions from United States Office of Personnel Management, Federal Fringe Benefit Facts 1980, 1980, Table 5-1, p. 15; and unpublished data from the Office of Personnel Management.

rates considered for estimating these tax expenditures. Also the reductions in the contribution limits and other provisions in the Tax Equity and Fiscal Responsibility Act of 1982 should reduce the pension contributions and accruals for some individuals in the high marginal tax brackets. Finally, the recommendation of the National Commission on Social Security Reform to tax Social Security benefits that was implemented in the Social Security legislation passed by Congress will raise marginal tax rates for many elderly pension recipients. Higher marginal tax rates among pension recipients should reduce the pension tax expenditures under the current estimation methodology.

The assignment of pension contributions across individuals in the Treasury's Tax Model has not been publicly described making it difficult to understand the reasons for or mechanics of adjusting tax rates for purposes of these calculations. The analyst who generated the pension tax expenditure estimates for the 1984 Budget did not know how such contributions were assigned in the model when we called to ascertain such information. Nor was he able to provide such documentation in time for development of this discussion.

One possible reason for using higher tax rate assumptions in the 1984 Budget calculations than used a year earlier is the inclusion of public workers, especially those employed by the Federal government. "The mean annual earnings from the total civilian population employed full time in 1977 was approximately $13,849. The mean annual salary level of Federal employees covered by CSRS in April was $16,000." 14/ Inclusion of federal workers with

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14/ Final report of the Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State and Local Government and Private, Nonprofit organizations (Washington, D.C., 1980), p. Inconsistencies in IRA and Pension Tax Expenditure Estsimates their higher than average earnings may account for the revised tax rate assumptions used to calculate the pension tax expenditures in the 1984 Budget.

Inconsistencies in IRA and Pension Tax Expenditure Estimates

The Special Analysis G in the Federal Budget does not include separate estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are imbedded in a broader category of retirement "plans for self-employed and others." Table 8 shows the tax expenditure estimates for this broader category from the last four Federal Budgets. One might have expected significant increases in the tax expenditure estimates between the 1982 and 1983 Budgets, in particular, because of the passage of ERTA and roughly doubling of IRA eligibility for 1982. Yet this 1982 tax expenditure estimate only increased by 11 percent between the two annual Budgets. In fact, the 1984 Budget estimate of the 1982 fiscal year tax expenditure was only 23 percent greater than the 1982 estimate in the 1982 Budget and 12.5 percent greater than the 1981 estimate inthe 1981 Budget.

TABLE 8

FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO NET EXCLUSION OF CONTRIBUTIONS TO RETIREMENT PLANS FOR THE SELF-EMPLOYED AND OTHERS PRESENTED IN SELECTED FEDERAL BUDGETS

BUDGET	FISCAL YEAR				
	1980	1981	1982	1983	1984
			(in millions)		
1981 Budget	$ 2,125	$ 2,520			
1982 Budget	1,925	2,105	$ 2,305		
1983 Budget		2,170	2,560	$ 3,760	
1984 Budget			2,835	3,755	$ 4,230

SOURCES: Special Analysis G of the Budget of the United States Government for Fiscal Years 1981-1984 (Washington, D.C.: Office of Management and Budget).

Even the 1983 Budget estimates might be understood since that Budget was prepared well before any substantive information on 1982 IRA utilization levels was available. But by the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years. For example, EBRI released the data in Table 9 in a news release on February 3, 1983. This information was picked up quickly in both the trade press and the conventional media. This includes such newspapers as USA Today and The Washington Post. Table 9 shows that the IRA contributions during fiscal 1982 had to have been at least $23 billion. In the development of the 1983 Budget, the 1981 tax expenditure for private plans was estimated at $23.4 billion (see Table 2) on contributions of $60.2 billion (see Table 7) and income on the trust funds. According to Munnell the average marginal tax rate of workers covered by a pension used to compute the pension tax expenditure was something in excess of 23 percent. 15/ If the average marginal tax rate of 23 percent is applied to the minimum of $23 billion in IRA contributions then the foregone federal tax would be around $5.3 billion for fiscal 1982. Few individuals are yet receiving significant IRA based annuities so the tax collections on such annuities cannot explain the discrepancy between the $5.3 billion estimated here and the $2.8 billion estimated in the 1984 Budget. The discrepancy is even harded to reconcile when the Budget's inclusion of Keogh plans is considered.

15/ Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982) p. 44. Munnell explains that the 23 percent rate was used to prepare the estimate for the 1981 Budget but that higher marginal rates were used in preparing the estimate for subsequent budgets.

Other Foibles and Inconsistencies

The abstract concept of tax expenditures that has been applied to private pensions for some years now. It has now been applied to state and local and federal civilian plans as well. Some might find it intriguing that the military retirement program is still not included in the 1984 Budget estimates of tax expenditures for employer sponsored retirement programs. The estimate does include some amount attributed to military disability benefits -- but they make up only about 9 percent of the military retirement program. The military retirement program paid $13.7 billion in benefits during fiscal 1981 and thus is the second largest pension plan in the United States, behind the Civil Service Retirement System. In many regards the military plan is the most generous large retirement program in this country today. In combination the federal civilian and military retirement programs cover about 5 percent of the total U.S. work force and paid retirement benefits in 1979 exceeding the benefits paid by all private pension programs. 16/

Why then, if including the federal civilian retirement program so significantly affects the tax expenditure estimates isn't the military retirement program included? One reason is that the militry retirement program is totally unfunded with outstanding unfunded liabilities at the end of fiscal 1981 of $476.9 billion. Under the computation method used to estimate them no tax expenditures arises in this case. There is no contribution to or interest paid to a trust fund since none exists. The benefits paid are all taxable since the program is noncontributory.

16/ EBRI ISSUE BRIEF "Federal Pensions: An Island of Privilege in a Sea of Budget Austerity" (Washington, D.C.: EBRI, July 1982) p. 5.
Since the funding pattern of the plan doesn't fit the mold assumed by the

computation method then the "tax expenditure" is ignored. In fact, the Civil Service plan is also largely funded on a pay-as-you-go basis. If these two retirement plans had met their normal cost contribution plus the 40 year annual amortization schedule stipulated in ERISA for private plans established before 1974, the total employer contribution to these two plans would have been $89.2 billion during fiscal 1981. 17/ This is 48.5 percent more than the total employer contribution going to all private plans in 1981 shown in Table 3 earlier. In other words, only one-fifth ($18.2 billion) of the employer contribution that would be required of private plans is considered in the tax expenditure estimates when the Tresury Department estimates these for federal plans. If the estimates of tax expenditures are to be consistent, then the federal plans' tax expenditure estimates should be generated on a basis consistent withthose that used to estimate the private plan number. Because of the significant differences in plans across the various sectors and the role of government sponsorship or regulation, the tax expenditure estimates should be presented separately for federal, state and local, and private plans.

Relationship to Other Tax Expenditure Categories

Each of the tax expenditures is calculated on an item by item basis at the margin. That is, each is considered to be an "exception to the normal structure" of taxes, but is calculated as though all other exceptions are part of the normal structure for purposes of deriving the estimate. This ignores the extent to which one "exception" might be magnified by its relationship to others.

17/ This is based on actuarial reports on the Civil Service Retirement System and military retirement program filed with the United States Congress in compliance with Public Law 95-595 for fiscal year 1981.

TABLE 9

ASSETS IN INDIVIDUAL RETIREMENT ACCOUNTS, 1981-1982

Financial Institution	Year-end 1981 (billions)	April 30, 1982 (billions)	June 30, 1982 (billions)	September 30, 1982 (billions)	December 29, 1982 (billions)
Commercial Banks 1/	$7.0	$13.0	$14.9	$16.2	$18.1
Mutual Savings Banks 1/	3.4	4.5	5.8	5.9	6.3
Savings and Loans 1/	9.2 2/	16.3	n.a.	n.a.	21.7 2/
Mutual Funds	2.6	4.0	4.3	5.0	n.a.
Credit Unions	0.2	0.5	n.a.	n.a.	n.a.
Life Insurance Co.	3.3	n.a.	4.6	n.a.	n.a.
Total Assets	$25.7	$41.6 3/	$46.4 3/	$48.5 3/	$56.2 3/

SOURCES: EBRI tabulations of data provided by Federal Reserve Board, National Association of Mutual Savings Banks, National Credit Union Administration, Federal Home Loan Bank Board, U.S.League of Savings Associations, Investment Company Institute and American Council of Life Insurance.

1/ IRA and Keogh deposits.
2/ Estimated.
3/ Baseline estimates using latest available date for each institutional category. The estimates provide a minimum total asset amount, which may underreport the actual amount of total assets outstanding.

For example, consider the case of a 66 year-old single man who received $8,400 in Social Security benefits during 1982 and an additional $8,400 in pension benefits. Assume there was no other income received and no special deductions considered for calculating tax liability. This person would have adjusted gross income of $8,400 under current law. He would be eligible for a double exemption since he was over age 65 and so his taxable income would be $6,400. Schedule X of 1982 Federal Income Tax Tables indicate a tax liability of $592.

Assume as an alternative, that this man had not enjoyed the double exemption for being over age 65 or the nontaxability of Social Security benefits. These two provisions of the tax law are considered to be "exemptions to the normal structure" because tax expenditures are calculated for them as well. The Treasury analysts use the actual $592 in taxes paid on current benefits to estimate pension tax expenditures. However, if these other two "exceptions to the normal structure" of taxes did not exist then the man's 1982 tax liability would be $592 without the pension or $2,546 with it.

It seems then that other "exceptions to the normal structure" give rise to large portions of tax expenditures attributed to pensions because they drastically lower marginal tax rates for the elderly. The utility of the pension tax expenditures estimates then, is extremely limited unless considered in the broader context of other tax provisions. Yet virtually no analysis of this kind is now available.

CONCLUSIONS

Many of the critics of pension programs point to the tax expenditure numbers as a basis for significant tax policy and pension reform. These critics have not applied their analytic capacities to any thorough discussion of the numbers that are published in the Budget each year. They have not considered the structure of other tax code provisions that affect the estimates. They have not considered the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than naive cross sectional analyses. They have totally ignored the inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological difficiencies in the calculation procedure.

Until the Treasury Department is willing to spell out in detail the derivation and numerical basis of these estimates they should be treated as nothing more than idle musings or random numbers. To seriously base any policy deliberation or decision on totally unsubstantiated, but clearly flawed numbers may result in the implementation of undesirable policies. There is an impression in the pension community today, however, that these tax expenditure estimates played a central role in the consideration of TEFRA. Furthermore, the recent precipitous changes in these estimates are seen as an ominous sign that additional pension reform is high on someone's legislative agenda.

The historical response of the pension system to the tax and regulatory provisions is fairly well documented. The pension system is clearly sensitive and responsive to policy change. This means that pension policy must be steady and even handed if the pension system is to be stable. Erratic policy or frequent adjustments will tend to destabilize existing pension programs and discourage employers from establishing new one.

Senator **Chafee**. I get your last point in that we don't want erratic policy or frequent adjustments. What suggestions do you have for us? For instance, do you have any comment on what we did last year?

Dr. **Schieber**. Well, as I stated in the testimony, I am not sure that all of the implications are fully understood. I think that freezing contribution limits is going to diminish the capacity of pensions over time to replace preretirement income. If they are frozen for any extended period of time, what that will do is shrink the size of the pension system relative to other retirement components. If that's what you want to do, I think that should be publicly debated. It should be discussed and should be fully understood before it is implemented.

I think that the withholding provisions, the annual form submitted to the recipients, is liable to cause some confusion; is liable to cause the kind of problems that have been noted relative to the Federal plan's although it has not been as well documented in the private plans.

But I guess the ultimate recommendation I would make is that in the future changes not be rapid and precipitous. That there be some general discussion among the Congress as well as the benefit community as to what the implication of these things are, and try and resolve them through kind of a mutual discussion process.

Senator **Chafee**. I think that makes sense. I think you are correct in sensing that this committee and the Congress is taking a look at overall employee benefits. Not just pensions, but overall employee benefits as an area that has gobbled up a lot of tax expenditures. And where there is a possibility of additional revenue, you get into equity. Some are getting the benefits of it and others aren't.

What do you make of the trend, that we are going more to defined contribution plans than defined benefit plans?

Dr. **Schieber**. Well, I included in my prepared testimony some discussion of the relative merits of defined benefits versus defined contribution plans. I sense that in certain areas of the policy community there seems to be a clear predisposition toward defined contribution plans. On the other hand, I sense that among workers, and to some extent among employers, that there tends to be more of a predisposition toward defined benefit plans. Now, what the analysis in the testimony tries to point out is that neither defined benefit nor defined contribution plans by themselves are totally perfect. They have both got some problems.

What you see happening with many large employers is they establish both types of plans. But I don't think there is a cut and dried predisposition that one type of plan is superior to the other as some people would suggest. And I am not sure that we should be pursuing policies that tend to encourage the termination of defined benefits plans, and encourages the creation of new defined contribution plans.

As an example of employee groups that are extremely concerned about the establishment of a defined contribution plan instead of a defined benefit plan, I point you to the Federal unions' concerns over the bill introduced by Senator Stevens last year that would establish a defined contribution plan for Federal workers. For all practical purposes, they have refused to discuss that particular provision or particular bill because they want to maintain a defined benefit plan.

There are a lot of groups on both the labor side of the benefits community and the employer side of the benefits community that are interested in the establishment and maintenance of good healthy defined benefit plans. And before we go marching off to eliminate those, I think we should look fairly carefully at the relative merits and what it is that the general public wants.

Senator CHAFEE. Last year when we were considering the TEFRA the aim was at the high income individuals. There was a good deal of talk in this committee about wealthy doctors, wealthy lawyers. So, the maximums were directed toward those groups. What has been the effect on the lower income individuals as a result of those changes, as best you can analyze it?

Dr. SCHIEBER. Again, I think it's premature to assess what the implications are yet. If you have got a plan where you have got a highly compensated individual at the top, and you have effectively reduced his ability or her ability to contribute to their retirement plan a percentage of their salary, there is the potential that those plans will be modified to keep the contribution rates up and down the salary scale consistent.

At this point in time I simply don't have any evidence that that is occurring. The evidence that seems to be coming through in the trade publications is that a lot of employers are establishing unfunded, excess, or nonqualified deferred compensation plans for their highly compensated executives.

I guess what I am saying is I really don't know yet. I'm not sure anyone does. Some of the benefit consultants and other people that are testifying later today may have a better intuitive feeling than I do because they are interacting with actual plan sponsors. I tend to be empirical in my observations.

Senator CHAFEE. Some lawyers are going to testify here later and I just wonder if they are going to say that the changes we made in the Keogh were fine except we don't permit any loans under Keogh. And, therefore, we should do that to conform with the qualified corporate plans. What do you think?

Dr. SCHIEBER. I guess my own concern is that if there are loan provisions—and I am not sure that there should be discrimination against one type of plan as opposed to another——

Senator CHAFEE. Suppose we eliminate the discrimination by just eliminating the loans for both?

Dr. SCHIEBER. Well, I think when you have loan provisions there is the potential for abuse of such loan provisions. I think if there is a fairly tightly specified set of limits or payback period such that retirement accruals are actually being saved for retirement purposes then the loan provisions may be reasonable.

Senator CHAFEE. Doesn't a loan provision just run completely contrary to the whole concept of what we are trying to do—accumulate money for a pension? Why in the world should somebody be entitled to borrow from it? I'm just warming you up for the lawyers or warming myself up for the lawyers. [Laughter.]

Dr. SCHIEBER. My feeling is that if these are tax-supported retirement programs that, in fact, their primary focus should be for providing retirement income security. To the extent that people come upon crises in their lives and need to tap certain assets that they have accumulated, it seems to me that that might not be an unreasonable proposition.

Senator **Chafee**. If you are starting down that road then we ought to have some drastic changes in the IRA's, for example.

Dr. **Schieber**. In terms of allowing loan provisions?

Senator **Chafee**. Sure. You said drastic changes in one's life. What's the difference? In IRA's you can't get the money out except if you pay an extra tax.

Dr. **Schieber**. Well, my fundamental feeling is that if any loan provisions—this is a personal comment—if there are any loan provisions that are allowed, there should be some requirement or stipulation to require that those moneys are paid back. That, in fact, this is a retirement-oriented program.

Senator **Chafee**. When do you think you would be able to give us some information on the effect of TEFRA?

Dr. **Schieber**. Well, right now we are cosponsoring an effort with the Department of Health and Human Services in the collection of some fairly extensive pension-IRA participation data. The data are being collected by the Bureau of the Census. To some extent we may have some analyses that we can do on those data by the end of this year or early next year. In addition, roughly a year from now we will be seeing any modifications in the plan creation rates that have occurred during 1983 and will be occurring in early 1984.

It is my impression that empirically we are not going to have much information for another year or maybe even 18 months.

Senator **Chafee**. All right, Doctor. Thank you very much. We rely upon your institute a great deal, and you have been helpful to us. And, certainly, we will be calling on you in the future. We appreciate you coming today.

Dr. **Schieber**. Thank you. Senator Chafee. The next panel will be Mr. Mentz, Mr. Piga, and Mr. Sporn. Gentlemen, if you will come forward.

STATEMENT OF J. ROGER MENTZ, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Mr. **Mentz**. Good morning, Senator Chafee. My name is Roger Mentz, and I am chairman of the New York State Bar Association Tax Section. We are an organization of over 2,900 members, all of whom are lawyers with a professional interest in taxation. We have among our members practicing lawyers, judges, professors, and also members of the Internal Revenue Service and the Treasury Department.

We have been involved in the subject of this hearing intensely for the past year or so. Last April, we prepared and published a very substantial report on professional incorporation. It's this report here, which your staff people are familiar with. And just today we have come out with another very substantial report, 131 pages, on the pension aspects of the TEFRA legislation, which we hope will be helpful to you.

In addition, we testified last year at the hearings on the Pension Equity Tax Act, the Rangel legislation, last June. The thrust of our earlier report and our testimony last year was on the point of pension parity for self-employed and corporate employees. And our basic position was that the law was running on a two-track system. You had one set of rules for self-employed, another for corporate employees. We argued strongly and apparently effectively that you shouldn't have two tracks. You ought to have one set of rules for retirement plans, employee benefit plans, that cover self-employed and corporate employees. We very strongly endorsed the approach of TEFRA in enacting that parity.

You mentioned the loan provision. There is still a slight disparity in the loan provision. It is in the very back of our report. We weren't planning to mention it this morning. But since you asked, we think a parity approach would require the same provisions, whether it be no loans at all or loans within limitations. They ought to be the same for either kind of plan.

Senator CHAFEE. Give me the philosophical background, of why originally the Keoghs, when they first came about after a tremendous effort by the self-employed, were so terribly limited. Wasn't the philosophy that we didn't want that type of approach? We wanted an overall corporate plan. I am not quite sure how that would work out if Keoghs were only doing the self-employed. Wasn't the idea that these were just temporary or modest plans, but the major thrust was toward the corporate or the overall plan?

Mr. MENTZ. Well, yes, initially there was, of course, no pension plan availability for self-employed individuals. And then they enacted a $2,500 deductible amount. Finally, I guess, in ERISA it went up to $7,500. I think Arthur Sporn who is cochairman—Arthur Sporn and Steve Piga on my left and right respectively are the cochairmen of our Employee Benefits Committee. They are really the employee benefit experts, and maybe I will let Arthur respond to that question more specifically, if you don't mind.

Mr. SPORN. Well, one observation I might make is I believe that the original reasons for the limitations on Keogh plans were largely received as fiscal constraints. The original Keogh legislation actually permitted, you will recall, a deduction of only $1,250, half of what might be put in. There was a lot of concern in 1962 about that. I recall that there were estimates that there might be as many as 750,000 Keogh plans instituted within a year of the time legislation was enacted. Actually, the number of plans adopted fell considerably short of that.

I believe that revenue constraints have been largely responsible for the holding back on the amount that could be contributed to a self-employed retirement plan up until TEFRA, which was a welcome change.

The other limitations have been, I think, the result of a perception that in the small employer area that there were more possibilities of manipulation, of depriving rank and file employees of benefits that should be provided to them coincidentally with the furnishing of the benefits to the proprietors.

Senator CHAFEE. All right. Why don't you go ahead, Mr. Mentz?

Mr. MENTZ. OK. As I said, we strongly endorsed the parity approach taken in TEFRA. We do have some problems with some of the other provisions in TEFRA as you might have gathered from the fact that we produced a 130-page report.

In particular, we think that TEFRA has created a topheavy monster. And while in particular the monster was really created by the House, I'm afraid that the Senate kind of let him get away in the conference committee, and now this topheavy monster is roaming around the country.

Let me tell you why I call the topheavy provisions a topheavy monster. As I noted, we recommend one set of rules to be applied in the employee benefit plan area. The area is already very complex, and you really do need specialists like Mr. Piga and Mr. Sporn to deal with the complexities. But where you have different sets of rules, it becomes almost impossible. And in TEFRA you have got three different sets of rules. You've got the basic rules for non-topheavy plans. You have a whole different set of rules for topheavy plans. And another set of rules for so-called super topheavy plans. So, you really have these three parallel tracks.

A plan can flip-flop from one track to another, from year to year under rules that are ambiguous and vague. And it's very difficult to tell in some cases which track a plan is on.

We think that this is the wrong approach to employee benefit legislation. The ideal approach, at least the way we see it, is to address the issues frontally. If you think that there is a problem in, let's say, discrimination, or vesting or integration, the preferred way of handling it would be the way that ERISA handled it, which was to address the problem and solve it with a statutory provision that applies across the board to all plans. We don't think that there is any reason to single out a particular kind of plan for a special kind of treatment, both on a policy basis and because in terms of administration it's a very, very difficult problem.

Senator **Chafee**. What do you say to what Dr. Schieber said? That this is an area that needs consistency and not erratic changes or annual changes.

Mr. **Mentz**. I agree it needs consistency. And I think consistency to me means the same rules applying to employee benefit plans across the board the way ERISA imposed them.

Senator **Chafee**. You are not deterred by the fact we just made some changes last year? You would recommend that we go ahead with these corrections this year even though it is one more change?

Mr. **Mentz**. Well, Senator, I'm not easily deterred. But let me say that our preference to you, our preferred recommendation, is that you get rid of the topheavy monster. It really is a monster. It's a mess administratively, and it will be a problem for generations. But if you don't agree, or if you can't kill the monster, we have a number of suggestions for chaining him down. Those are more or less in the neighborhood of technical suggestions that are incorporated in the report to make the law administrable and semiworkable. I won't ever concede that it will be workable. I think the right answer is the demise of this monster. But we do have a number of recommendations for you. Mr. Piga will be addressing them in his testimony.

Senator **Chafee**. Fine. Mr. Piga, this is an incredibly complex area, as you know. Furthermore, it's something that we didn't deal with as Mr. Mentz mentioned last year. It emerged from the House. We didn't consider it here. So, I will not suggest that I am intimately familiar with it.

Mr. **Piga**. Pardon?

Senator **Chafee**. I will not suggest I am intimately familiar with it. So, what I am saying is that in a short time I would like you to just point out some of the major things you think we ought to change, and you have that in your report. What report is that, Mr. Piga?

Mr. **Piga**. This is the report. We have not yet distributed it because we couldn't carry enough down for everybody.

Mr. **Mentz**. It is available today.

Senator **Chafee**. It looks like a weighty document.

Mr. **Mentz**. It is.

Senator **Chafee**. Go ahead, Mr. Piga.

Mr. **Piga**. You want me to address one of the problems today?

Senator **Chafee**. Go ahead. You have got 5 minutes. [Laughter.]

STATEMENT OF STEPHEN M. PIGA, EMPLOYEE BENEFITS COMMITTEE, NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Mr. **Piga**. Well, as Mr. Mentz testified, we welcome the parity provisions. I will skip through that and get to the reaction of large corporations in my experience as to the enactment of TEFRA. I think that TEFRA has been greeted with a large yawn in this area. With the exception of the tremendous amount of paperwork generated by the legislation, which most taxpayers have come to expect out of any pension legislation, there has been little concern on the part of large corporations. You might say that the new amendments provided by 415 on how much you can contribute and how much you can accumulate by way of benefits should have application. But executives don't care.

All you have done by the enactment of TEFRA is shift the benefits to an unfunded area. There is one result which may be very serious in the future. You have caused, I think, by the enactment of TEFRA additional unfunding of pension liabilities in the corporate area. This has the result of mortgaging future earnings, and is, I think, comparable to some of the causes threatening the demise of the social security system.

All TEFRA has done, too, in this area is postpone pension deductions rather than eliminate them altogether. We also think that small businesses have perceived the TEFRA legislation as being specifically anti-small business. We say that because it is inevitable that sooner or later the plans of small business will become topheavy.

The alternatives to a small business are to terminate plans or to accept the topheavy provisions, which are burdensome enough. But I think it is particularly unfair and inequitable so far as small businesses are concerned in that once they accept the fact that they are topheavy and provide the minimum benefits and provide the minimum vesting, that they are then also saddled with this tremendous and enormous paperwork burden that Mr. Mentz referred to.

Senator **Chafee**. Your testimony is somewhat at odds with Dr. Schieber's who said that he could not draw conclusions like the ones you are drawing. What are you basing your conclusions on?

Mr. PIGA. I'm basing the conclusions on the statute itself and some of the interpretations that have come out since its enactment. And our report gets into this in great detail. We've concluded that the key definitions are in many respects irrelevant to the statute's goals. That they are vague, they are ambiguous, they are duplicative, they may be subject to manipulation, they cause unsolvable dilemmas and administrative burdens for sponsors, for the administrators and the Internal Revenue Service. That the key employee look back rules are so complex that they may require determinations that are impossible to make. We've concluded that the test based on accumulated accrued benefits and aggregate account balances have serious shortcomings. And when you add to it the add-back rules, you have even the probability of manual calculations in this very difficult area because people just don't keep records on prior distributions and have never done so.

We have these tracking problems which existed under the old self-employed rules. The owner-employee rules were enacted some 21 years ago and nobody has still figured out how some of these things work. The super topheavy provisions, we think, serve no useful purpose whatsoever. And, finally, as far as our conclusions are concerned, we think that plan disqualification is particularly inappropriate in a statute which is designed in large part to protect the rank and file employees.

The rank and file employees suffer as much as anyone else in a plan disqualification situation. I can give an example of what I mean about these things being so cumbersome and unworkable. I will give one which I think is particularly bad.

The definition of key employee includes any plan participant who is among the 10 highest top owners——

Senate CHAFEE. That is covered in your statement. That is quite a problem, as you point out.

All in all you are not very enthusiastic about it. [Laughter.]

Mr. PIGA. I would like to point out one thing further in response to an earlier question that you asked the prior witness. I think you questioned the appropriateness of loans in retirement plans.

In my experience, loan provisions are very appropriate in certain types of plans. As you know, there are a lot of thrift and savings plans out there that have as an objective not only accumulation of moneys for retirement years, but are designed to encourage employee savings. And, particularly, savings for particular purposes, such as education, illness, new residence, and that type of thing.

The thrift plans and the profit-sharing plans which cover literally hundreds of thousands of people have loan provisions. And I think they are very, very appropriate in that type of a plan.

Senator CHAFEE. Well, sure they are very, very appropriate, but why should they get a tax benefit while they are doing it?

Mr. PIGA. Well, it's not a tax benefit. They are borrowing money.

Senator CHAFEE. They are setting the money aside. They are getting a tax benefit when they set the money aside. Why should they be able to do that?

Mr. PIGA. I'm talking about the large thrift plans where people borrow out of it and they pay it back.

Senator CHAFEE. Sure they pay it back. But they have set the money aside tax free.

Mr. **Piga**. Well, they are not getting deductions for it. True, their accounts are accumulating tax free. But they are borrowing money from it. Whether it is appropriate or not, it exists in the case of hundreds and thousands of people out there. And to take this way at this junction it seems to me is not quite fair.

Senator **Chafee**. Well, are you suggesting that I'm not conceding you are right on that last point. Are you suggesting there are no problems in the so-called topheavy area?

Mr. **Piga**. No problems?

Senator **Chafee**. No problems that deserve correction.

Mr **Piga**. Oh, no; we agree entirely with the Treasury Department's statement of policy in the pension area. We agree that these plans should not be tax havens for the highly paid. We agree that the rank and file ought to share equally and equitably in plan benefits. There are problems, and we think the problems ought to be addressed frontally if they are to be addressed at all. Not through some back-door approach such as these key employee and topheavy provisions.

Senator **Chafee**. Do you have suggestions on how to do it?

Mr. **Piga**. Oh, yes.

Senator **Chafee**. In your document?

Mr. **Piga**. Yes; we do.

Senator **Chafee**. OK. Does that complete your testimony?

Mr. **Piga**. I could go on all day. [Laughter.]

Senator **Chafee**. You are not going to have the opportunity.

STATEMENT OF ARTHUR D. SPORN, EMPLOYEE BENEFITS COMMITTEE, NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Senator **Chafee**. Mr. Sporn, do you have something?

Mr. **Sporn**. Yes. I would like, if I could take a moment, Senator Chafee, just to try to put the changes that were made by TEFRA in a perspective of the rules governing the employee benefits area and how they have impacted the previous situation.

The pre-TEFRA situation was a troublingly complex, we believe, an overly voluminous set of rules, rules which we think were quite out of proportion in many cases to their purposes and to the amounts involved. There are examples in our report. The Treasury Department has clearly been overwhelmed by the need for regulations interpreting many provisions of ERISA enacted 9 years ago. Regulations dealing even with certain of the original Keogh legislation have never been promulgated.

I think the same excessive complexity which ERISA to a considerable extent introduced has led to a sense of apathy, indifference to compliance as the result of being overwhelmed on the part of business. I think it's highly significant, for example, that just this past January, 9 years after the enactment of ERISA, the service found it necessary to issue a notice giving a further extension for compliance with certain of the ERISA requirements.

Now the significance of this is that we believe that TEFRA has aggravated this already unhealthy situation in introducing an entirely new set of highly complicated rules, rules which govern amounts of liability, which in many cases are relatively small. One good example to illustrate the impracticality of the key employee rules is if you look in the neighboring area of group life insurance, to which they have been carried over. There are plans which will have to deal with the problem of determining key employees over a 5-year period in the group life insurance area even though these are employers who have no concern whatsoever as to top-heavy status, either because the employer has no retirement plan or because this plan is clearly not topheavy, or because if the plan is topheavy it meets the topheavy vesting and minimum benefit requirements.

All of this, I might point out, is the same torturous process of determining key employees for determining a maximum taxable amount in the group life area of some $978 a year and hence a tax of less than $500. I believe there is another example of the administrative complexity which TEFRA has created, which is pointed up very clearly in the loan area. If loans are permitted we find that under the statute as TEFRA left it, there are no less than three separate rules which apply to the taxability of loans which are treated as distributions.

Regular employees are treated one way, key employees who receive distribution prior to age 59½ from a topheavy plan are treated a second way. On top of that there is still a vestige from the pre-TEFRA law of an absolute prohibition leading to a penalty tax of as much as 100 percent on loans which are made to an owner employee or to any member of the family of an owner employee.

All of these classifications, these highly elaborate classifications, in which people's status change, pose very serious administrative problems as to how you deal with them when a person's status changes.

Senator CHAFEE. What do you think would happen if we did away with the loans entirely?

Mr. SPORN. Well, in the pension area itself, Senator, I believe there is something that can be said for it. I believe that as Mr. Piga has pointed out there are large areas of the qualified deferred compensation world where retirement is not the exclusive or in some cases even the primary objective. I think that loans from defined contribution plans which are not oriented primarily or exclusively at providing retirement benefits have a good deal to be said for them.

Senator CHAFEE. All right. Anything else?

Mr. SPORN. Well, a third example, which I mentioned just briefly, is in the penalty tax area where once again TEFRA has complicated things and has introduced an imperfect correlation between section 72(m)(5) and the rules dealing with the taxability of distributions in general. We believe this ought to be corrected. But beyond that, I believe that this complication once again points up the fact that the introduction of the topheavy classification has contributed to an excessive growth of complicated internally inconsistent tax rules within the entire employee benefit area. And some simplification, some administratively workable system is imperative.

Senator CHAFEE. Now in your full report you cover how we might do it?

Mr. SPORN. We do, sir.

Senator **Chafee**. It's so trite to say it's complicated, but I guess with all things we deal with around here this is about as complex as anything. We appreciate the help you gentlemen have given us. We will try to accommodate some of the problems that you have raised.

Mr. **Mentz**. I might say, Senator, that the tax section would be pleased to work with members of the staff in any effort to simplify the legislation if we can.

Senator **Chafee**. Fine. Thank you very much. I want to thank each of you for coming. Mr. Sporn was a member of what we consider to be the most distinguished class at Harvard Law School in some years.

Mr. **Sporn**. I welcome the opportunity of appearing before you, Senator.

Senator **Chafee**. Nice to see you again.

Mr. **Piga**. Can we leave these reports with you so we don't have to bring them back to New York?

Senator **Chafee**. It will cut your airfare back. Yes. Mr. Wilkie will take them.

Thank you, gentlemen.

[The prepared statements of Mr. Mentz, Mr. Piga, and Mr. Sporn follow:]

PREPARED STATEMENT OF ROGER MENTZ, STEPHEN M. PIGA, AND ARTHUR D. SPORN, ON BEHALF OF THE NEW YORK STATE BAR ASSOCIATIONN,;

Mr. Chairman and members of the Committee:

My name is J. Roger Mentz. I am the Chairman of the New York State Bar Association Tax Section. The Tax Section has over 2,900 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, teachers, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service. It is our privilege to testify before you today on the effect of changes in the Tax Equity and Fiscal Responsibility Act of 1982 on the private pension system.

The Tax Section has been actively involved in the legislative process that resulted in the employee benefit tax legislation contained in TEFRA. In April of 1982 we published our Report on the Incorporation of Lawyers and Law Firms, in which we recommended that "Congress establish legislative parity of self-employed qualified plans with corporate plans," a recommendation which we were pleased to see adopted in TEFRA. We testified at the Ways and Means Committee hearings on H.R. 6410, the Pension Equity Tax Act of 1982. Just last week the Tax Section approved a very substantial report of our Employee Benefits Committee on the pension provisions of TEFRA. This report was prepared under the direction of Stephen M. Piga and Arthur D. Sporn, Co-Chairmen of our Employee Benefits Committee, who are here with me today. The report is available today for members of the Senate Finance Committee and staff.

There is a common thread that runs through the Tax Section's testimony last year and its reports: one set of legal rules should apply to employee benefit plans, rather than two or three different sets of rules that depend on the employer's form of organization (e.g., corporation vs. unincorporated business), type of business (e.g., "personal service corporations" as defined in Section 6 of the Pension Equity Tax Act of 1982), or Key Employee plan participation (the "top-heavy" and "super top-heavy" provisions of TEFRA). As we testified before the Ways and Means Committee, a dual or triple set of legal rules is just the wrong statutory mechanism in this very difficult technical area. We believe that perceived abuses in the employee benefit area should be addressed frontally, and if statutory remedies are determined to be appropriate, they should apply to all plans, not just to a narrow grouping of plans where the distinctions will necessarily be arbitrary and where plans will flip-flop between different sets of rules.

Thus, the Tax Section has a fundamental policy disagreement with the top-heavy plan rules. We recommend their legislative repeal on policy grounds. Furthermore, we believe that the top-heavy plan rules have so complicated an already difficult area of the law that the complexities by themselves should cause a reconsideration of the legislative approach. It is our perception that these new rules are contributing to the substantial decline in the number of new defined benefit pension plans, which are the foundation of a sound employee benefit structure because they provide a steady income flow after retirement.

If it is not politically possible to adopt the "one track" approach advocated by the Tax Section, then we believe that the statutory rules regarding top-heavy plans must be substantially revised if they are to be made administrable by employers and enforceable by the Internal Revenue Service. We also have recommendations to present to you with regard to the TEFRA amendments to the Section 79 group life insurance provisions, the employee loan provisions of TEFRA, and the penalty tax on premature distributions as modified by TEFRA. In addition, our report covers the new contribution and benefit limitations imposed under TEFRA and the changes in income and estate tax treatment of distributions from qualified plans and IRAs.

As Chairman of the Tax Section, I am fortunate to be able to draw on the members of the Tax Section as a substantial reservoir of talent on many different tax subjects. Few areas of the tax law are as specialized as employee benefits -- and in few areas are the talents of experts so necessary. It is my privilege to introduce to you the Co-Chairmen of the Tax Section's Employee Benefits Committee, Stephen M. Piga and Arthur D. Sporn, who practice extensively in the employee benefits area and will describe to you in more detail our legislative recommendations.

Mr. Piga will now discuss the top-heavy plan rules.

My name is Stephen M. Piga. I am Co-Chairman of the Employee Benefits Committee of the Tax Section, a committee consisting of about 160 lawyers. I understand that the purpose of today's hearing is to ascertain some of the effects of TEFRA on private pension plans. I think the responses that your Subcommittee will receive on this subject will be as diverse as the backgrounds of the people appearing before you.

Witnesses, including this witness, having interests in law firms, accounting firms and other traditional unincorporated service organizations welcome the TEFRA parity provisions. As an unincorporated partner in an unincorporated law firm having no incorporated partners, I applaud the pension parity provided by TEFRA for self-employed individuals. The tax system has for too long been unfair to self-employed individuals whose income-producing capacities immediately cease when by reason of death, physical or mental disability or age they are no longer capable of rendering services. Large corporate institutions can and do take care of employees and their families in such situations; whereas we and our families are virtually on our own. We are grateful for the parity enacted by TEFRA.

Witnesses having interests in large corporations will, on the other hand, have entirely different perceptions of TEFRA. Based upon my own experience, I believe that representatives of large corporations have thus far greeted the TEFRA pension provisions with a large yawn. The reason for this reaction is simply that the substantive changes in the law will have very little practical application to this group, except for the generation of a huge amount of paperwork which taxpayers have come to expect as a result of any major legislation affecting pension plans. The reduced limits on contributions and benefits mandated by TEFRA in the case of highly paid corporate executives will, of course, have technical application. But very few executives care. In most cases these reduced limits will simply shift the source of their benefits from qualified plans to the corporate treasury, but will not result in benefit reductions. The question of whether the mortgaging of future business operations with unfunded accruals of pension liability is or is not sound economic policy is beyond the scope of my expertise. But one need only look at the recent threatened collapse of the Social Security system to appreciate that sound funding of pension obligations is a prudent course and that unfunded pensions can build up to enormous numbers. However, I will not and cannot take issue with the revenue enhancement features of TEFRA, except to point out that a policy which limits pension deductions merely postpones the revenue loss and does involve economic risks.

Small businesses will, of course, be greatly affected by the TEFRA pension provisions since it seems inevitable that all or most plans of this group will be top-heavy sooner or later. Some witnesses will say, with substantial justification, that TEFRA is an anti-small business statute so far as pensions are concerned. I am compelled to agree with this conclusion. The alternatives available to small businesses will be fairly simple. They can either continue their plans within the top-heavy rules or terminate their plans and provide for their benefits through non-qualified arrangements. Witnesses having interests in small businesses will question why they have been singled out for special adverse treatment, especially in those situations where employers have in fact been fair and equitable in providing benefits to rank and file employees. But assuming the concept of top-heaviness is retained in the tax laws, the decision to continue or discontinue plans should be strictly a business judgment based on the economics and personnel consequences of the alternatives. However, once the business decides to continue the plan and provides the minimum TEFRA benefits, there is absolutely no justification for imposing on the plan a whole new set of burdensome administrative requirements, particularly on those plans which may be top-heavy in some years and not top-heavy in other years.

Middle sized businesses, I think, will be particularly hard-hit by TEFRA, particularly the top-heavy provisions, because of the uncertainties and administrative burdens. We have concluded in our report that the Key Employee definitions are largely irrelevant to the statute's policy goals; that the definitions are vague, ambiguous, duplicative, may be subject to manipulation, may cause unsolvable dilemmas and will cause expensive and undue administrative burdens for plan sponsors, administrators and the Internal Revenue Service; that the Key Employee look-back rules are so complex that they may require determinations impossible to make with any certainty; that tests based on cumulative accrued benefits and aggregate account balances have serious shortcomings and, when coupled with the prior distribution add-back rules, may result in expensive manual calculations, and are of doubtful relevance to the question of whether a plan is meeting the social objectives addressed by TEFRA; that annual determinations of top-heaviness and non-top-heaviness lead to tracking problems not yet even solved under the old owner-employee rules adopted in 1962, some 21 years ago; that the super top-heavy provisions serve no useful purpose; and that plan disqualification is certainly not an appropriate sanction in a statute designed to protect rank-and-file participants.

One or two simple examples will demonstrate that the conclusions set forth in our report regarding the top-heavy plan rules are not exaggerated. Take a medium sized corporation with publicly traded stock. Under TEFRA any plan participant becomes a Key Employee if he becomes at any time during a five year period one of the ten largest shareholder-participants. This means that the corporation must be able to ascertain on every day over a five year period those employees who own any of its stock because if at any time an employee becomes one of the top ten shareholders in the employee plan group, he is then considered a Key Employee for that year and four years thereafter. As a practical matter, it is impossible for the corporation to perform this exercise, especially when the constructive stock ownership rules must also be considered and when, in fact, many of the shares are held by brokerage houses in the names of their nominees. Yet if the corporation cannot demonstrate which employees are the top ten shareholder-participants during any part of this five year period, how can it be assured that its plan is not top-heavy? And how can the Internal Revenue Service make a determination?

Take another corporation with one shareholder who owns 100% of the outstanding shares. Assume the corporation's plan is clearly top-heavy and that the sponsor wishes to avoid providing the minimum benefits required by TEFRA. The simple expedient is to give one share to each person employed by the corporation. Under the TEFRA rules each employee then becomes one of the top ten owners and all employees are Key Employees not entitled to the minimum TEFRA benefits. Obviously, this result is not only irrelevant but is ridiculous. Although the Proposed Regulations indirectly and commendably address this absurdity by excluding from the top ten group those earning less than $30,000 a year, this does not eliminate the possibility that there can be 50 or 100 or 1,000 top ten owners!

Our report gives other illustrations of how the TEFRA rules are ill-conceived, may be irrelevant and do in fact lead to administrative burdens of incredible complexity. Although it is impossible to get into all these illustrations at this time, I hope that our report* will be useful to the Congress and its staff in addressing these problems.

Finally, some witnesses might say, as they did in the case of ERISA, that the only group which really welcomes the TEFRA pension provisions without reservation is the service industry consisting of lawyers, actuaries and consultants who specialize in employee benefit matters. It is undoubtedly true that TEFRA has generated substantial service business in this area and will continue to do so. I have engaged in the practice of employee benefits law for many years and will undoubtedly share in this business. But, as contrasted with ERISA, which directly addressed important social problems for all qualified plans, the TEFRA pension provisions, and particularly the top-heavy TEFRA provisions, in my view, establish a new set of artificial, impossible and irrelevant rules to get indirectly at perceived problems which may not even be touched by the rules. I think there are far more important matters to take up the time and efforts of serious professionals, including government professionals, than concerns about the application and operation of a brand new set of complex concepts which will certainly produce an abundance of administration and paperwork but will produce very little else in terms of substantive progress.

Mr. Sporn will now discuss the TEFRA provisions covering group term life insurance, employee loans, and the penalty tax on premature distributions.

*The report was made part of the official committee files.

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My name is Arthur D. Sporn. I am Co-Chairman of the Employee Benefits Committee with Mr. Piga.

We are troubled by the fact that over the years the rules governing the income, estate, and gift tax treatment of qualified retirement plans and other employee benefits have grown excessively voluminous and complex, in many cases all out of proportion to the amounts involved and to the purposes of the rules laid down. This volume and complexity have not only overwhelmed the Treasury Department, but have also induced a sense of being overwhelmed in many businesses, leading, as a result, to noncompliance on their part. In this connection, I note that the Treasury Department recently again extended the deadline for compliance with ERISA requirements, clearly indicating that nine years after its enactment there is still need for relief. Regulations interpreting many important provisions of ERISA, enacted in 1974, and even of the original Keogh legislation enacted in 1962, have never been promulgated.

We are particularly concerned because we believe that TEFRA has seriously aggravated this already unhealthy situation, in introducing extensive new and even more complicated rules, rules which govern liability for amounts of tax which are relatively small, and which apply only to certain categories of taxpayers, who in turn must be identified by highly complicated status tests.

Perhaps the best example of this infirmity in the legislation passed last year is furnished by the extension of the new

Key Employee rules to areas other than that for which they are primarily formulated, that of top-heavy plans. Mr. Piga has already outlined some of the serious difficulties which we believe the Key Employee definition will cause in connection with the top-heavy requirements, but there at least we are dealing with significant sums, up to $30,000 per taxpayer per annum in the case of defined contribution plans and possibly more in the case of a defined benefit plan. Consider, however, the administrative complications which the Key Employee rules promise to provide both taxpayers and the Service in connection with group term life insurance, under new Section 79(d), and in connection with employee loans, under new Sections 72(m)(5) and 72(p).

Group Term Life Insurance

With group term life insurance, since the basic exemption covers only $50,000 of insurance, the maximum amount at stake for any one taxpayer is less than $1,000 per year ($1.63 per month per thousand, in the 60 to 64 age bracket, x 12 x 50% = $978). In order to determine whether this amount (or less) is potentially payable by any taxpayer, it will first be necessary to make an initial determination as to whether the employer's group life arrangements discriminate in favor of Key Employees as to

(a) eligibility to participate, and

(b) the type and amount of benefits available.

Discrimination as to eligibility is to be tested under four alternative criteria, including two safe harbors and a general nondiscrimination test such as is applicable to qualified retirement plans. At no place in the statute or its legislative history, however, does one find any consideration of a basic economic fact of life and how this impacts on nondiscrimination: many employee group life insurance arrangements are offered to employees only on a contributory basis. Moreover, the tests for nondiscrimination as to eligibility and benefits must be applied to the employer group under the aggregation rules of Section 414 -- although this complication is perhaps unavoidable if manipulation is to be prevented.

When and if one should make a determination that a given group life plan is discriminatory, the employer must then determine the Key Employee group who are to be taxed on the cost of their first $50,000 of insurance. This determination must be made with all of the complications applicable in the top-heavy area, as previously described, including the 5-year look-back rule. It should be borne in mind that this problem of determining the Key Employee group may apply to many employers who have no concern with the classification under the top-heavy rules, either because they have no qualified retirement plan, or because their plan is clearly not top-heavy, or because the plan, whether or not top-heavy, clearly meets the minimum benefit and minimum vesting requirements of Section 416. All of this for the purpose of determining a maximum potential liability of $978 per taxpayer!

and, except for home loans, a cap of 5 years on the permissible term.

Self-employed individuals are not eligible for the group term life insurance exclusion in any case, a situation which we consider unfair and deserving of correction.

Employee Loans

The employee loan area also points up the unjustifiable complications which TEFRA has introduced. ~~Except for home loans~~, New Section 72(p) puts a cap on permissible loans from qualified plans of not more than $50,000 or one-half of the vested (accrued) benefit credited to the employee's account. Loans in excess of this amount, or which are made for a nonpermissible term, are taxable as distributions. So far so good, but we find that loans which become taxable as distributions have different consequences for three different categories of employee taxpayers:

1. For a non-Key Employee, the amount of the deemed distribution is taxable as ordinary income.

2. However, a loan from a top-heavy plan which becomes a distribution to any employee who is or has been a Key Employee, if made before he has reached age 59-1/2 or becomes disabled, becomes subject in addition to the 10% penalty tax under Section 72(m)(5). As a result any top-heavy (or potentially top-heavy) plan which includes loan provisions will have to maintain a permanent, cumulative roster of all participants who fall within the Key Employee classification. This will be so even though the top-heavy provisions of Section 416 may otherwise be of no concern whatsoever to the plan,

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since it meets the minimum benefit and vesting requirements of Section 416.

3. The tax complications of loans from qualified plans do not stop with Section 72. If a loan is made to any participant who is a 10% owner-employee, or to any member of the family of such an owner-employee (including a 5% shareholder employee of a Subchapter S corporation), it also constitutes a prohibited transaction subject to the 5%-100% penalty tax under Section 4975.

All taxing provisions which impose liability on the basis of a taxpayer's falling within a special status pose an inherent and troublesome complication of determining how they apply to a taxpayer whose status changes, and the Section 4975 penalty tax on loans to owner-employees furnishes a good example. Suppose that a valid loan is made to an employee who is the brother (or the son) of a 7% partner in the business, and while the loan is outstanding the latter's ownership percentage increases to 10%. Does the loan automatically become a prohibited transaction? Does it attract the penalty tax unless it is promptly repaid? If a taxpayer seeking guidance on this question turns to the Regulations under Section 4975, a provision enacted as part of ERISA some nine years ago, he finds that Regulations dealing with the status of loans to owner-employees under Section 4975(d) have not yet been promulgated. He may engage in further research which uncovers the fact that the prohibition in Section 4975(d) is essentially the same as that formerly set out in Code Section 503(g), prior to its repeal by ERISA. However, he will find that even the Regulations dealing with loans to owner-employees under Section 503(g) (Reg. §1.503(j)-1) gave no consideration to the change in status problem.

We do not wish to belabor unduly the lessons drawn from the changes made by TEFRA in the taxation of group life insurance and employee loans. On the immediate level, we believe it is obvious that the new Key Employee rules have rendered the "owner-employee" concept superfluous, making its retention an indefensible complication in any sensible system of tax administration; it ought to be comprehensively deleted from the Code, even if the present Key Employee classification, or any modification thereof, is to be retained.

On a more general level, we believe that these two examples point up the fact that the greatest possible restraint should be exercised in enacting tax rules which impose special tax liabilities only on taxpayers who fall within special classifications, particularly classifications under which the taxpayer's status is likely to change from year to year. In some cases perhaps special rules and classifications may be necessary to prevent abuse, but in such cases the classifications should employ bright line tests which permit status to be determined with reasonable certainty and without excessive effort, and to be determined to the greatest extent possible on the basis of current data.

We believe that the present Key Employee tests fall far short of these criteria. We have serious doubts as to whether it is desirable to retain at all in the employee benefit area a system which imposes special tax rules on a special class of taxpayers, such as Key Employees. However to the extent that such a system must be retained, the Key Employee test should be drastically modified and simplified.

Penalty Tax on Premature Distributions

If I may touch once more on the penalty tax on premature distributions under Section 72(m)(5), the new provision suffers from other deficiencies, in addition to the complications it injects in the tax treatment of plan loans. As a technical matter, the metamorphosis of Section 72(m)(5) under TEFRA from a penalty tax on owner-employees to a penalty tax on Key Employees appears to be incomplete. I believe it is clear that the references to owner-employees that remain in the caption and text should be deleted or revised. But even with this technical correction, and apart from its unfortunate use of the Key Employee classification, new Section 72(m)(5) is inequitable in its limited application and at cross purposes with other provisions of the Code. As we point out in our report, any premature distribution to a corporate or other common law employee will, in nine cases out of ten, be a distribution on termination of employment, eligible for rollover and hence for exclusion from gross income, and hence not subject to the penalty. Even if a terminating common law employee does not roll over a lump sum that he receives, the same distribution which attracts a penalty tax under Section 72(m)(5) will usually be eligible for the special advantages of 10-year averaging, under Section 402(e). Virtually the only taxpayer bearing the full brunt of the 10% penalty will be a Key Employee partner withdrawing from his partnership who receives a distribution from the firm's plan before reaching age 59-1/2. We belive such a result is unfair, discriminatory, and contrary to the parity approach taken in TEFRA.

We would recommend that new Section 72(m)(5) and Section 402(e) be properly correlated, by making amounts subject to the penalty tax ineligible in all cases for 10-year averaging. Even more important, we believe that if it is to be possible to avoid the penalty tax by rolling over one's distribution, as we strongly believe should be the case, the rollover privilege under Section 402(a)(5) must be extended to distributions to a withdrawing partner regardless of his age.

Senator **Chafee**. The next panel is Mr. Oppenheimer, Mr. Allen, Mr. Holan, and Mr. Harris. I understand Mr. Paley is here instead of Mr. Harris.

Mr. **Paley**. Yes, I am.

Senator **Chafee**. All right. Mr. Handy is present with Mr. Oppenheimer.

We welcome you all here. Gentlemen, why don't we start with Mr. Oppenheimer and Mr. Handy.

STATEMENT OF JERRY L. OPPENHEIMER, MAYER, BROWN & PLATT, WASHINGTON, D.C.

Mr. **Oppenheimer**. Thank you, Mr. Chairman.

For the record, I am Jerry L. Oppenheimer, and I appear as counsel today to The ERISA Industry Committee, or as you know it, ERIC. Mr. Handy is, as I believe you know, vice president of Employee Benefits for Textron, and he also serves as a director of ERIC.

ERIC's some 100 members sponsor very large, long established and well funded plans which provide significant pools of long-term savings and meaningful retirement benefits to rank and file employees. We estimate that 20 percent of all participants in private pension plans participate in plans sponsored by ERIC members. Clearly, they and their employees have a major interest in TEFRA and any other legislation which impacts employees' plans.

As you know, there was grave concern when the Finance Committee held no hearings to consider the impact of TEFRA before it was enacted. Although we appreciate the opportunity to appear today, we ask you to keep in mind the very important differences between holding a hearing when legislation is pending and holding a hearing after the legislation has been adopted to consider its consequences.

Senator **Chafee**. I think that's a fair comment. [Laughter.]

Mr. **Oppenheimer**. We thank you, sir.

Senator **Chafee**. There is a difference.

Mr. **Oppenheimer**. We do hope that last year's experience will prove to be unique and that this hearing will lead to the restoration of more meaningful and broader considerations of these proposals.

Senator **Chafee**. Well, I don't want to suggest that last year's experience was unique, but we will try to talk to you before we do the deed.

Mr. **Oppenheimer**. Well, we would appreciate that, Mr. Chairman.

Our most important concern is the growing feeling that TEFRA is only the latest harbinger of constant change and increased cost, especially for defined benefit plans. For example, one major employer has concluded that unless the legislative and administrative environment improves, it will simply terminate all of its defined benefit plans. Another is seriously considering terminating plans because the constant change is nibbling us to death. A third complains that pension administration has become a matter of catching up with too frequent legislation and too often delayed regulations, leaving little time for long range planning, plan improvement or efficient plan administration.

ERIC members are, of course, aware of the continuing focus on the seemingly ever-increasing estimates of tax expenditures. They are also aware of many of the proposals that are pending before various congressional committees. It cannot be urged too strongly that the proposals which come before the Finance Committee involve more than short-term revenue. They affect real people, their planning and their financial security, as well as long-term savings and capital formation.

Many feel strongly that there should be a moritorium on any additional legislation which requires review of and or amendment to existing plans or procedures. There's a broadly based feeling that piecemeal legislation will only be detrimental to plan participants and their beneficiaries.

Mr. Chairman, in the limited time since this hearing was announced we have not been able to consult fully with all ERIC members. The specific problems noted today in our prepared statement are illustrative of the concerns of large employers, but we request the opportunity to file a more complete statement for the record, if that seems appropriate.

Senator CHAFEE. That is fine. How long do you think is needed?

Mr. OPPENHEIMER. Well, I would hope that we could submit it by the announced date that the record will close, which I understand is the 25th.

Senator CHAFEE. All right.

[The prepared statement of Mr. Oppenheimer follows:]

PREPARED STATEMENT OF JERRY L. OPPENHEIMER, A MEMBER OF MAYER, BROWN & PLATT, ON BEHALF OF THE ERISA INDUSTRY COMMITTEE

Mr. Chairman, I am Jerry L. Oppenheimer, a member of Mayer, Brown & Platt. I appear as counsel to The ERISA Industry Committee (ERIC), an organization of some 100 major employers which maintain retirement and other employee benefit plans for their employees. With me is Edward O. Handy, Jr., Vice President - Employee Benefits, Textron Inc. Mr. Handy also serves as a Director of ERIC.

Mr. Chairman, ERIC members sponsor long-established, well-funded plans which provide significant pools of long-term savings and meaningful retirement benefits to their rank and file employees and their beneficiaries. We estimate that 20 percent of those protected by private pension plans are participants in plans sponsored by ERIC members.

Clearly, ERIC members and their employees have a major interest in TEFRA and any other legislation which would impact employees' plans. There was grave concern when the Finance Committee held no hearing and afforded no other meaningful opportunity to consider the impact of TEFRA on these plans before it was enacted. There was a similar concern when, with no meaningful opportunity for comment, last month the Committee expanded the House Social Security bill to tax all nonqualified deferred compensation amounts.

Although we appreciate the opportunity to appear today, we ask you to keep in mind the very important differences between holding a hearing when legislation is pending and holding a hearing after the legislation has been adopted to consider its consequences. We hope that last year's experience will be proven unique and that this hearing will lead to the restoration of broader consideration of the consequences of legislation before it is enacted.

Mr. Chairman, our most important concern is the growing feeling that TEFRA is only the latest harbinger of constant change and increased costs, especially for defined benefit plans. For example, one major employer has concluded that, unless the legislative and administrative environment changes, it will simply terminate all of its defined benefit plans. Another employer is also seriously considering terminating plans because the constant change is "nibbling us to death". Another complains that pension administration has become merely a matter of "catching up" with too frequent legislation and too often delayed regulations, leaving no time for long-range planning, plan improvement, or efficient plan administration. Defined contribution plans are seen by many as a means to minimize or eliminate much of the constant disruption and increased cost, but they generally do not provide the same ascertainable retirement benefits to retirees or as generous benefits for those who become participants relatively late in their careers.

ERIC members are, of course, aware of the continuing focus on the seemingly ever-increasing estimates of "tax expenditures" for pension plans and other fringe benefits. They are also aware of many of the legislative proposals affecting employees' plans that are pending before various committees of the Congress. It cannot be urged too strongly that the proposals which come before the Finance Committee involve more than short-term revenues; they affect real people, their planning and their financial security, and long-term savings and capital formation. Thus, there must be a truly meaningful opportunity to consider the full implications of any proposed change.

Many feel strongly that there should be a moratorium on any additional legislation which requires review of and/or amendment to existing plans or procedures. There is a broadly based feeling that piecemeal legislation can and will only be detrimental to the interest of plan participants, their beneficiaries, and the nation's retirement system.

Mr. Chairman, in the limited time since this hearing was announced, we have not been able to consult fully with all ERIC members. Thus, the following specific problems are illustrative of the concerns of large employers, but we request the opportunity to file a more complete and technical statement for the record if that seems appropriate after further consultation.

It is clear, Mr. Chairman, that TEFRA has had an immediate impact on those now planning retirement. Its payout requirements restrict many participants' ability to provide income security for dependent siblings, aged parents, divorced spouses, or mentally or physically handicapped children. One large employer reports that over the last three years one-third of the annuity options elected by retiring participants would not have complied with the TEFRA requirements. The potential revenue gain from the payout requirements is insignificant, especially when compared to the problems presented.

TEFRA has also had an immediate impact on retirees. Large employers have made significant efforts to explain TEFRA's pension withholding provisions, but many retirees, including many who owe no tax, were confused and upset by notices that TEFRA's withholding provisions could reduce their current pensions unless they filed elections. Because TEFRA requires annual notices, this confusion will be repeated year after year after year. The pension withholding provisions, which, unlike withholding on interest and dividends, became effective last January 1, directly and significantly increased administrative costs for many employers. Eliminating annual notices would reduce future administrative costs and retiree confusion.

TEFRA requires that large plans be amended to include meaningless (and, thus, confusing) boilerplate language to comply with the requirement that all plans include TEFRA's top heavy provisions unless they are specifically excused by Treasury regulations. This requirement is costly and frustrating and could, of course, have been avoided if Congress had taken the time to distinguish large plans which will never become top heavy from those which might, rather than deferring the problem to the Treasury and Internal Revenue Service.

Mr. Chairman, TEFRA's reduction in limits on plan benefits and contributions has had only limited immediate impact on employees of large employers. However, the hasty enactment resulted in important technical deficiencies which might have been avoided. For example, employers are finding it extremely difficult to work with the transitional rules generally and as they apply to union negotiated single employer plans and with the reduced combined fraction which applies where there is both a defined benefit and a defined contribution plan.

More important is the concern over the reduced limits' long-range implications regarding funding and the potentially significant increase in retirement benefits being provided by unfunded excess benefit plans, which is contrary to ERISA's basic requirement of current funding. In this context, we note with particular concern the recent suggestion to freeze indefinitely the index to the limits which TEFRA temporarily suspended but would reinstate in 1986. Employers are concerned that, without the index, significant numbers of employees would be affected in five or ten years.

ERIC members are, of course, aware of the continuing focus on the seemingly ever-increasing estimates of "tax expenditures" for pension plans and other fringe benefits. They are also aware of the various legislative proposals effecting employees' plans before the full Committee and the other Committees of the Congress. It cannot be urged too strongly that any modification of the tax laws involves more than short-term revenues; it involves real people and their financial security; it also involves long-term savings and capital formation. Thus, there must be a truly meaningful opportunity to consider fully the implications of any change.

Many feel strongly that there should be a moritorium on any additional legislation which require review of and/or amendment to existing plans or procedures. There is a broadly based feeling that piecemeal legislation can and will only be detrimental to the interest of plan participants, their beneficiaries, and the nation's retirement system.

Mr. Handy and I thank you for the opportunity to appear and look forward to your questions.

Mr. **Oppenheimer**. With your permission, Mr. Handy would like to comment briefly.

Senator **Chafee**. All right. We are delighted to welcome Mr. Handy.

STATEMENT OF EDWARD O. HANDY, VICE PRESIDENT, EMPLOYEE BENEFITS, TEXTRON, INC., PROVIDENCE, R.I., ON BEHALF OF THE ERISA INDUSTRY COMMITTEE [ERIC], WASHINGTON, D.C.

Mr. **Handy**. Senator, I am here to express my appreciation for your interest in private employer pension plans, not the world's most interesting subject, I think.

Senator **Chafee**. I don't think we will make the front pages on this subject.

Mr. **Handy**. The company that I work for, Textron, has 14,375 pensioners. Our plan distributed $49.5 million last year. We are perhaps atypical in that we have a large number of plans. We have about 77 domestic pension plans. It's kind of a bear to administer. But the 20 of us who devote our lives to it find that we believe we are doing a lot for Textron employees, and we believe we are shouldering a burden that might otherwise fall on the public if we weren't there doing it.

It's kind of interesting to look back on the days when I first went to Textron. There was one lady who ran the pension department with a little bit of help from a G. William Miller who later became chairman of the Federal Reserve. Now we have a department of 20, with 2 lawyers, 1 actuary, and 6 accountants. So while we like the job we are doing, you fellows have made it a little bit more complicated for us over the years.

Senator **Chafee**. We've guaranteed your steady employment.

Mr. Handy. That's exactly right.

There's one point that I would make, perhaps two. The first one is not of great significance but it addresses what has become a legislative habit. That is, amending section 401(a) almost yearly so we have to change our plan to include the newly required language. And it involves a great deal of busy work. A recent example is the requirement to include topheavy rules. We have to include language in most of our 77 plans. There are some exemptions. Although there is, I think, absolutely no possiblity that any one of our plans would ever be topheavy, what the change means is that the lawyers get out their pencils and draft their documents. We have plan booklets that include plan provisions. And the plan booklets have to be revised if the plans are going to be up-to-date. And the fact that you have to do it once isn't so bad, but when it happens every year, it does create a great deal of busy work. And what we don't need in our economy is busy work right now.

And I might address a second problem that came to my mind when I looked at a chart in the report of the National Commission on Social Security Reform. It was included in Senator Armstrong's views. There was a little graph that showed how social security costs were going up for the average wage earner to approximately $10,000—that's employer and employee—in 1990. That's a lot of money. And our contributions to pension plans this year were about $57.6 million. And that's a lot of money. And those two systems are designed to provide retirement income. And it really doesn't make much sense to fund out of the public exchequer a life of ease where the guy gets paid more for not working than he does for working. So the two retirement systems should be coordinated.

Our primary salaried plan is not very well integrated with social security. We have been working for about two years on improving that. And it involves going to actuaries and getting all kinds of cost estimates, and it involves redrafting plans and considering communication programs to explain it to the 40,000 employees—in this case it would be less than that. But there is a lot of work involved in it.

And the Rangel bill fortunately didn't pass. But it may come to pass again or it may come to your attention again. They wanted to change radically the integration rule. And a radical change in the integration rules has tremendous ripple effects through the system. And I just would hope that you would go as slow as you possibly can on this kind of change and not make it without consulting with as many people as possible, as long as possible.

We would be glad to answer any questions you have.

Senator CHAFEE. Well, I think the points you've made are good ones. Certainly it's not the objective of this committee to create a lot of busy work for industry and businesses in the country.

So I think what you have brought before us will be helpful, and we will try to incorporate it into what we are doing, and see if we can't reduce the ambiguity, the conflicts, and the host of problems that have been raised by what we did last year.

Mr. HANDY. The threat of constant change——

Senator CHAFEE. That's the problem. So we try and straighten it out, and then you will be back next year saying it's this constant change that is killing us.

Mr. HANDY. I promise I can only do this every other year, Senator. [Laughter.]

Senator CHAFEE. As Mr. Schieber said when he first testified, we need a little consistency and peace, and I think tranquility in this area. And if we follow your suggestions, even though it might simplify things, we would have one more set of changes. It is so complex that it seems to me that everything done in this area has all kinds of ramifications, ripple effects, that go way down through the system whether you are dealing solely with topheavy or something else.

Mr. HANDY. The integration rules are there. They are well established. They are not well understood, and never will be because they are too complicated. But they are as well understood as that kind of rule probably can be by the technicians that administer it. And I would just hope that you would go very slowly before you change those.

Senator CHAFEE. Change the integration rules?

Mr. HANDY. That's right.

Mr. OPPENHEIMER. Mr. Chairman, one last comment. There are changes and there are changes. And I think that it is possible to make changes that would simplify the system without necessarily requiring people to revise their basic plans or their basic documents.

Senator CHAFEE. All right.

Mr. HANDY. The legislative habit that I referred to is amending section 401(a). Everytime there has been a legislative change, people have to run around and change all their plans. And that's the thing that really does create the problem.

Senator CHAFEE. Thank you, Mr. Handy, Mr. Oppenheimer.

Mr. Allen.

STATEMENT OF EVERETT T. ALLEN, CHAIRMAN, BENEFITS POLICY COMMITTEE, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. ALLEN. My name is Everett Allen, and I am here today representing the Association of Private Pension and Welfare Plans. We are a nonprofit organization founded in 1967 with the primary goal of protecting and fostering the growth of the employee benefit system.

We represent some 600 organizations across the United States, including hundreds of plan sponsors—both small and large employers alike. Additionally, our membership includes leading organizations from every element of the employee benefit community which supports the private benefit system—investment firms, banks, insurance companies——

Senator CHAFEE. Mr. Allen, it's a little hard to hear you. Could you perhaps speak a little louder or speak into the mike a little more?

Mr. ALLEN. We very much appreciate the opportunity to be here today and to comment on the effect of TEFRA as it affects private pension plans. The serious adverse long-term effects from the barrage of legislation and regulations since 1974 were given very little consideration during the development of the TEFRA pension provisions. The short-term revenue gains from the TEFRA pension provisions, less than 2 percent of the total expected revenue gain from TEFRA, pale in comparison to the long-term policy effects.

Senator CHAFEE. I think we have got to remember in all discussion here today that we weren't solely looking for revenue as I mentioned. We recognized that revenue was a modest part, but we were striving for equity. That's what the thrust was. The feeling is that some people are getting away with privileges they shouldn't get away with. The argument that we are dealing with a little bit of revenue, I would drop that idea if I were you.

Mr. ALLEN. All right. In any event, we think it's critical to acknowledge that TEFRA is just the latest of a series of legislative and regulatory actions that have affected employee benefit plans. The ability of these plans and their sponsors to assimilate and respond to these sharply escalating requirements was clearly under severe strain before TEFRA and has been exacerbated by TEFRA.

In addition to this voluminous amount of recent legislative and regulatory change, Congress is now considering legislation that when added to the current load of compliance issues could crush the ability of plan sponsors to even attempt to comply with all these provisions for current plans and would totally discourage the adoption of new plans. Among the legislative proposals now being considered by Congress or we expect to be considered are unisex actuarial assumptions, single employer termination insurance, health insurance limits, taxation of fringe benefits, elimination of the inflation factor in the limitations on contributions and benefits.

In sum, the current state of legislation and regulations has placed a tremendous weight on employers which will result in substantial administrative expense and cause total confusion. The confusion arises from the fact that on the one hand Congress has repeatedly stated that a viable, healthy private pension system is the key to the security of future elderly Americans, especially in light of recent troubles with social security; on the other hand, the effect of the actual legislation enacted and regulations issued is exactly the opposite to contract the private system by providing no incentives for employers to sponsor new plans and many disincentives for maintaining current plans.

Another of our concerns is the process by which legislation regulating the private pension system has been enacted. The result of the process when full and complete hearings are not held and all interested parties are not heard from is a product like TEFRA—poorly crafted legislation that traps taxpayers, contains policy decisions of questionable merit, and engulfs taxpayers in complexity.

We will illustrate this with a few examples, but we emphasize that they are only illustrations. Attached is a complete list of suggested changes; these changes were prepared and adopted on behalf of the APPWP by a committee of APPWP members, subject to approval by the legislative council of the APPWP at the APPWP's annual meeting on May 25, 1983.

[The suggested changes from Mr. Allen follow:]

APPWP ERISA AMENDMENTS COMMITTEE

SUGGESTED TEFRA CHANGES

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), signed into law by President Reagan on September 3, 1982, did not follow the legislative process normally accorded tax legislation. As a consequence, there was little or no time for the public to comment on most of the TEFRA provisions in the employee benefit area.

The Association of Private Pension and Welfare Plans ("APPWP") strongly believes that the changes made by TEFRA and other legislation since the enactment of ERISA in 1974 have been adopted without understanding their impact on the private pension system. Accordingly, we urge that the Congress take the time to review the private pension system, its strengths and weaknesses, prior to enacting future legislation such as TEFRA.

In the interim, however, certain provisions in TEFRA should be clarified by regulations or the statute should be amended; otherwise, it will be difficult for plan sponsors to comply with TEFRA. This paper describes these areas, which require regulatory or legislative relief.

Under each heading below is a brief description of the TEFRA provision followed by those areas where the Association believes clarification is necessary.

I. IRC § 415 Limits.

TEFRA has made several changes to the overall limits on contributions and benefits under qualified plans and other individual retirement plans. The dollar limit on the annual addition under defined contribution plans and the dollar limit on the annual benefit under defined benefit plans are significantly decreased. All cost-of-living adjustments to these amounts are suspended until 1986. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan is reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as applied to percentage of compensation limits). A series of special transition rules is provided under TEFRA with respect to these changes.

- The obscurity of the transitional rules in TEFRA § 235(g)(1)(ii) and the IRS interpretations of the rules in Notice 82-19 (11/3/82) and Notice 83-4 (3/12/83) give rise to uncertainty and insufficient time for planning. Accordingly, we seek statutory relief as follows:
  - deferral of the effective date of Code § 415 changes until years beginning after 12-31-83

in order to permit plan sponsors to comply with the new TEFRA rules. The deduction for contributions to fund amounts in excess of the 1982 Code § 415 limits would be carried over and become deductible when the Code § 415 limits are subsequently adjusted to cover the amount of the excess; thus, no revenue loss would be sustained.

- fresh start rules should apply for years beginning after 12-31-83.
- in determining the defined contribution fraction, a plan sponsor should only be required to maintain records on and after 1-1-84. Plan sponsors should be permitted to use good faith estimates where records are unavailable for earlier dates.
- an effective date of limitation years for Code § 415 changes and taxable years for Code § 404 changes should be provided.

II. Top-Heavy Plans.

Under TEFRA, additional qualification requirements are provided for plans which primarily benefit an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation which may be taken into account, (2) provide for more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees. Further, additional restrictions are placed on distributions to key employees.

- The effective date of the top-heavy rules should be postponed to the later of plan years beginning after 12-31-84 or six months after the publication of final regulations in order to resolve unanswered questions and provide Congress with sufficient time to eliminate or modify the needless requirements of the top-heavy rules. There appears to be general agreement on the need for amendments to the top-heavy requirements. Unless the effective date of the top-heavy provisions is deferred, plan sponsors will be required to engage the advisors necessary to comply with the TEFRA provisions and complete hopelessly complicated record searches and calculations all of which may be unnecessary if many of the agreed-upon revisions are adopted.
- Legislation should be adopted to exempt plans with a top-heavy test ratio of 30% or less, based on the test described in Code § 416(a)(1) or based

on the information relating to accrued benefits on the Form 5500, from the requirements of including plan language containing the top-heavy rules and from doing the test each year.

- Legislation should be adopted to provide for the following:
  - that the account balance or accrued benefit of all former employees or a beneficiary of any such employee need not be taken into account under Code § 416(g)(3) in determining whether a plan is top-heavy. Thus, only in-service withdrawals would be taken into account under the five-year lookback rules.
  - that the only employees who are key employees in a plan year are those who were key employees on the immediately preceding determination date. Even though the regulations published by the IRS resolve this issue, the statutory provision should be amended in order to avoid potential future litigation.
  - an exclusion of voluntary employee contributions, whether or not deductible, from the computation of whether a plan is top-heavy. The voluntary savings feature of a plan

should not be taken into account because, unlike the employer contributions, the employer has no control over the employees who will avail themselves of this benefit, which must be offered to all participants and is limited in amount.

- permissive aggregation of collectively bargained plans with non-bargained plans without regard to the comparability of benefits under the plans. Thus, an employer would receive credit for all the benefits provided under all plans in testing for top-heaviness.
- that key employees on the first determination date should be made without regard to the five-year lookback rule.
- that the transition from top-heavy to non-top-heavy will not prohibit a shift to a non-top-heavy vesting schedule for all participants, with respect to amounts not fully vested and future benefits at the time of the shift. Once a plan is not top-heavy, the general rules should apply as if it were never top-heavy.
- a limit on the total number of shareholders to not more than 10 earning minimum compensation of $150,000. The expansion beyond

10 owners under the legislative history and IRS proposed regulations needlessly complicates top-heavy calculations and seems to exceed the statutory directive. The failure to require a minimum level of compensation causes many lower-paid employees to become key employees even though their status is not conceived to be one to which top-heavy rules are directed.

- that minimum benefits or contributions in all events need not exceed that provided to key-employees. Thus, for instance, defined benefit plans which use career average pay as a basis for accruing benefits under the plan may continue to use this basis under the minimum benefit rules.
- repeal of the premature distribution rules of Code § 72(m)(5).

o Regulations should be promulgated to clarify the following:

- that each plan in an aggregation group may use the plan's interest rate assumption, if such rate is reasonable.

- that a top-heavy plan need not provide minimum benefits or contributions to employees who are not entitled under the plan to share in contributions or accrue benefits. Thus, plans should be permitted to exclude employees who are not participants because they fail to complete 1,000 hours of service, or fail to make mandatory contributions.
- that minimum benefits under either a defined benefit or defined contribution plan will satisfy the top-heavy requirements. An employer should not be required to provide a five percent minimum contribution as prescribed under the proposed IRS regulations.

III. Withholding.

TEFRA provides that payors generally will be required to withhold tax from all designated distributions (the taxable part of payments made from or under qualified retirement plans or other forms of deferred compensation plans) unless, after notice, the participant elects to have no withholding.

o Legislation should be adopted to provide for the following:

- elimination of the two-notice rule in Code § 3405(d)(10)(B)(i)(II).
- flat dollar withholding (whether or not in excess of the minimum).
- an exemption under Code § 6704(c)(3) of all good faith failures to withhold or keep records.

IV. Loans.

Under TEFRA, any amount received by a participant as a loan from (1) a qualified retirement plan or (2) other types of retirement or individual retirement plans, will be treated as a distribution to the participant unless certain requirements are met.

- o Regulations should be promulgated to clarify that the taxable income derived under Code § 72(p) is not deemed a distribution otherwise violative of Code § 401(k).
- o Code § 72(p)(2)(B) should be amended to provide that refinancing of a loan is not deemed an impermissable extension.
- o Income arising under Code § 72(p) should be statutorily exempted from wage withholding.

V. Distributions from Qualified Plans.

TEFRA requires that all distributions from qualified plans be made within five years of the death of the participant and the participant's spouse.

The intent of Congress was to prevent avoidance of taxes by an unreasonable deferral of benefits and to provide for parity among corporate and non-corporate plans. The major abuse of extended deferral was eliminated by the reduction of the estate tax exclusion under Code § 2039(c). Thus the provision under Code § 401(a)(9) is unnecessary but if retained would have the unfortunate result of prohibiting socially desirable practices found in many corporate and state and local government plans. These include the following:

1. Child's survivor income benefits payable until the child reaches an age such as 18.
2. Survivor income benefits payable to a dependent parent.
3. Joint and survivor benefits payable to the participant and a joint annuitant other than the spouse (such as a divorced spouse, a sister, etc.).

- Code § 401(a)(9) should be amended to permit the past practice of making distributions over a period of years to any individual selected by the participant.

VI. Parity.

TEFRA generally eliminates distinctions in the tax law between qualified retirement plans of corporations and those of self-employed individuals.

- The process of equalizing corporate and non-corporate plans by eliminating non-corporate restrictions should continue until completely equalized.

VII. Elective Contributions for Disabled Employees.

TEFRA permits an employer to elect to continue deductible contributions to a profit-sharing or other defined contribution plan on behalf of an employee who is permanently and totally disabled.

- Code § 415(c)(3)(C)(ii) (denying the application of the rule to a participant who is an officer, owner or highly compensated employee) should be deleted.

Mr. **Allen**. The effect of provisions with respect to the new 415 limits place the employer in a trap. A little less speed in passing the legislation and a little more thought could have avoided this trap. It works as follows: The annual pension benefit for an employee may not exceed $90,000 starting January 1, 1983. However, the plan need not be amended to provide for this limit until January 1, 1984. This difference in time between the effective date of the new limit and the necessary plan amendment reflecting the new limit creates a potential trap for plan sponsors. Without amending the plan, a participant is required to receive the benefit earned under the plan regardless of whether it exceeds the new limit. If it does exceed the new limit the employer is not permitted to deduct the amount necessary to fund the benefit, nor is the employer permitted to cancel the benefit because of other ERISA restrictions. Thus, postponing plan amendments until 1984 is a trap which will cause employers to fund nondeductible excess benefits under the plan.

Besides such traps, we believe that many of the policy decisions reflected in TEFRA are not well conceived or not carefully thought out. For instance, TEFRA substantially reduces the estate tax exclusion for distributions under qualified retirement plans. At the same time, if benefits have not commenced prior to a participant's death, plans will be required to distribute benefits within 5 years following death. This was intended to prevent participants from accumulating large amounts under the plan in order to take advantage of pre-TEFRA estate tax exclusion. Once the estate tax exclusion was capped by TEFRA, the provision for required distributions became much less significant. Yet, the TEFRA provision was drafted to be as broad as if the pre-TEFRA estate tax exclusion still remained. This results in preventing the participant from selecting legitimate options without tax motives to provide distributions over a longer period for his or her minor children and handicapped individuals.

For example, the retirement plan of one of our members provides a noncontributory survivor benefit of 30 percent of accrued pension for survivors. For a slight reduction in pension, the employee can elect an additional 20-percent benefit. Thus, in the event of the employee's death prior to retirement, his surviving spouse will receive 50 percent of the pension for the rest of the spouse's life.

In the absence of a surviving spouse, the benefit is paid to dependent children, defined to be those under 19 or under 23, if students, and in particular children over 19 if they are mentally or physically handicapped. Therefore, a handicapped child is assured of a lifetime income under the plan if his or her parents are both deceased. It has also been the past practice of this employer when granting ad hoc pension increases to apply that increase to the survivor benefit as well.

Under the TEFRA 5-year rule, survivor benefits could no longer be provided to dependent children, nor to dependent parents, nor to any other eligible survivors in the absence of a surviving spouse. Further, the 5-year rule has the effect of shifting responsibility for those survivors back to the public sector by eliminating a lifetime income stream provided by the private sector.

If the private system is a desirable socioeconomic institution, it must be able to grow in a healthy manner. Congress and the administration must step back, refrain from redoing or reframing the pension law every 2 years, and allow the multiple changes to be assimilated over a period of time. Otherwise, we cannot even determine what impact each successive wave of legislation is having on the pension system.

Pension programs are not adopted for the short term. Careful deliberations are involved in choosing and installing such a system. It is put there to stay; therefore, it must be able to rely on some basic Government policies rather than be threatened with extinction by each new class of legislators. It is a wonder how anyone can install a defined benefit pension plan in today's political climate.

Today, we are being asked to express our views on the impact of TEFRA after it has been enacted. If we are to have a coherent and workable pension policy, we must air the issues before enactment and come to grips with the pitfalls of new legislation.

We urge you to consider the following fact and question: According to EBRI, in 1979 just over 26 percent of employees in firms of under 25 employees were covered by a qualified plan as compared to over 91 percent of employees in firms with more than 1,000 employees. What incentives can Congress provide to encourage sponsorship of plans for these small entity employees? Complexity and confusion are not incentives. Nor are increased legislative and regulatory requirements.

We appreciate this opportunity to provide you with our views, and we hope we will proceed together in the future in the common goal of strengthening the private pension system.

Senator CHAFEE. Thank you.

[The prepared statement of Mr. Allen follows:]

PREPARED STATEMENT OF EVERETT ALLEN, ON BEHALF OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and Members of the Subcommittee, my name is Everett Allen and I am here today representing the Association of Private Pension and Welfare Plans, Inc. (APPWP). The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefits system. The Association represents some 600 organizations located across the United States. Our member firms include hundreds of plan sponsors--both large and small employers alike. Additionally, our membership includes leading organizations from every element of the employee benefits community which supports the nation's private benefits system: investment firms, banks, insurance companies, accounting firms, actuarial and benefit counsulting firms, and various others associated with employee benefit plans. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

We appreciate this opportunity to appear before the Subcommittee to comment on the effect of the pension provisions in the Tax Equity and Fiscal Responsibility Act of 1982 on private pension plans.

We strongly believe that the TEFRA provisions result in substantial additional burdens on most pension plans at a time when plan sponsors are still struggling to comply with the multitude of legislation and regulations which has developed after the enactment of ERISA. When plan sponsors begin to be informed of what is required to comply with the law, we expect a backlash against the added burdens of maintaining a qualified retirement plan. The reason that we have not seen evidence of this yet is the delayed effective date for most of the provisions until 1984.

The serious adverse long-term effects from the barrage of legislation and regulations since 1974 were given very little consideration during the development of the TEFRA pension provisions. The short-term revenue gains from the TEFRA pension provisions -- less than two percent of the total expected revenue gain from TEFRA -- pale in comparison to these long-term policy effects. In fact, most of the pension revenue gain comes from only one change to Code § 415. Thus, most of the policy changes in TEFRA will have little impact on revenues but a major impact on the health of the private pension plan system.

We think it is critical to acknowledge that TEFRA is just the latest of a series of legislative and regulatory actions that have affected employee benefit plans. The ability of employee benefit plans and their sponsors to assimilate and respond to these sharply escalating requirements was clearly under severe strain before TEFRA was enacted and was exacerbated by TEFRA.

The following is not a complete list, but merely a sampling of the recent outpouring of legislative and regulatory requirements, e.g., final regulations under section 415 on the maximum annual contribution or benefit allowed for each employee and under section 411 on suspension of benefits (both provisions were added by ERISA); the ADEA amendments of 1978 on mandatory retirement ages in plans; 1980 legislation on affiliated service groups; IRS rulings on vesting at normal retirement age rather than at normal retirement date and on the statement of actuarial assumptions in the plan; TEFRA rules revising the amount and manner in which the maximum annual contribution or benefit is computed; loans limited to the lesser of $50,000 or 50% of the employee's account except for certain principal residence mortgages; withholding at different rates, depending on the form of payment, the payee, and the form filed; different contribution or benefit rates and different vesting schedules if key employees receive a certain percentage of the benefits; revision of the manner in which employer contributions for social security benefits may be used to determine the amount of benefits due under the employer's plan; restrictions on the provision of group term insurance; and imposition of health insurance costs on the employer for older employees even though Medicare would ordinarily cover such employees. We could go on for pages.

Moreover, within a few months of the enactment of TEFRA, sweeping Social Security changes were made. Private plan sponsors must now review concepts of normal and early retirement ages and the integration of private plan benefits with those under the Social Security Amendments.

In addition to this voluminous amount of recent legislative and regulatory changes, Congress is now considering legislation that, when added to the current load of compliance issues, would crush the ability of plan sponsors to even attempt to comply with all these provisions for current plans and would totally discourage the adoption of new plans. Among the legislation proposals now being considered by Congress, or we expect to be considered, are:

A. Unisex actuarial assumptions
B. Single employer termination insurance
C. Health insurance limits
D. Taxation of fringe benefits
E. Elimination of the inflation factor in the limitation on contributions and benefits.

In sum, the current state of legislation and regulations has placed a tremendous weight on employers, which will result in substantial administrative expenses, and cause total confusion. The confusion arises from the fact that, on the one hand, Congress has repeatedly stated that a viable, healthy, and expanding private pension benefits system is key to the security of future elderly Americans, especially in light of the recent troubles with the Social Security system. On the other hand, the effect of the actual legislation enacted and regulations issued is exactly the opposite - to contract the private pension benefits system, by providing no incentives for employers to sponsor new plans and many disincentives for maintaining current plans.

The long range implications of this trend is that plan sponsors must be prepared to expend substantial resources year in and year out to comply with changes in the law. This trend must be reversed, and any future legislation must relieve plan sponsors from the excessive and needless regulation of ERISA, TEFRA, and other legislation. Our Association has prepared an analysis of ERISA reforms which we believe, if adopted, would eliminate many of the ERISA impediments. In addition, we have started an analysis of the TEFRA provisions with recommendations for reform. We expect to have this paper on TEFRA reform completed soon and to submit it and the ERISA amendments paper for the record.

Another of our concerns is the process by which legislation regulating the private pension system has been enacted.

The result of the process when full and complete hearings are not held and all interested parties are not heard from is a product like TEFRA--poorly crafted legislation that traps taxpayers, contains policy decisions of questionable merit, and engulfs taxpayers in complexity.

I would like to illustrate this with a few examples, but I should emphasize here that these are only illustrations, and, as I previously stated, we will submit a complete list of suggested changes before the record closes.

The effective date provisions with respect to the new Code § 415 limits place an employer in a trap. A little less speed in passing the legislation and a little more thought could have avoided this trap. The trap works as follows: The annual pension benefit for an employee may not exceed $90,000 starting January 1, 1983. However, the plan need not be amended to provide for this new lower limit until January 1, 1984. This difference in time between the effective date of the new limit and the necessary plan amendment reflecting the new limit creates a potential trap for plan sponsors. Without amending the plan to provide for the new limit, a participant is required to receive the benefit earned under the plan regardless of whether such benefit will exceed the new limit. If the benefit earned under the plan exceeds the limit, the employer is not permitted to deduct the amount necessary to fund this benefit. Moreover, the employer is not permitted to reduce the participant's benefit to satisfy the new limits because of other ERISA restrictions. Thus, the postponement of plan amendments until 1984 is a trap which will cause employers to have to fund non-deductible excess benefits under the plan.

Besides such traps, we believe that many of the policy decisions reflected in TEFRA are not well conceived or have not been carefully thought out. For instance, TEFRA substantially reduces the estate tax exclusion for distributions under qualified retirement plans. At the same time, if benefits have not commenced prior to a participant's death, plans will be required to distribute benefits within five years following the participant's death. This was intended to prevent participants from accumulating large amounts under the plan in order to take advantage of the pre-TEFRA estate tax exclusion. Once the estate tax exclusion was capped by TEFRA, the provision for required distributions became much less significant. Yet the TEFRA provision was drafted to be as broad as if the pre-TEFRA estate tax exclusion still remained. This results in preventing the participant from selecting legitimate options, without tax motives, to provide distributions over a longer period for his or her minor children or handicapped individuals.

For example, the retirement income plan of one of our members provides a non-contributory survivor income benefit equal to 30 percent of accrued pension for survivors of eligible employees. For a slight reduction in pension at the time of retirement, an employee can elect an additional 20 percent benefit. Thus, in the event of such an employee's death prior to retirement, his surviving spouse will receive 50 percent of his pension (unreduced for early retirement) for the rest of his or her life.

In the absence of a surviving spouse, the benefit is paid to a dependent child(ren). The term "dependent child" includes an unmarried child under age 19 (23, if full-time student), and a child 19 and older who is mentally or physically handicapped. Therefore, a handicapped child is assured of a lifetime income under the plan if his or her parents are both deceased. It has also been the past practice of this employer when granting ad hoc pension increases to apply that increase to the survivor benefit as well.

Under the TEFRA five-year rule, survivor benefits could no longer be provided under the plan to dependent children, nor to dependent parents, nor any other eligible survivors in the absence of a surviving spouse. Further, the five-year rule has the effect of shifting responsibility for those survivors back to the public sector by eliminating a lifetime income stream provided by the private sector.

Finally, TEFRA has engulfed many in unintelligible complexity. To illustrate this point, one of our members, the National Automobile Dealers and Associates Retirement Trust, a master plan maintained for automobile dealerships throughout the United States, has given us a questionnaire they have designed to elicit information from automobile dealers in an attempt to determine which individual plans are top-heavy. There are four types of key employees under the top-heavy provisions. In order to determine one type--the five percent owner--the questionnaire asks the following question:

> List all employees who are five percent owners of your company. In determining this, please use the following rules: an employee is considered to own the stock owned, directly or indirectly, by or for his spouse, children, grandchildren, and parents; an employee who is a partner in a partnership or a beneficiary of an estate or trust is considered to own his proportionate share of the stock owned, directly or indirectly, by the partnership, estate, or trust; an employee who owns five percent or more in a corporation that owns, directly or indirectly, any of your company stock is considered to own the company stock in that proportion which the value of the corporation stock which the employee owns bears to the value of all the corporation stock.
>
> Please redo the foregoing calculations for each of the 4 preceding years.

Can anyone expect a businessman to comprehend this? More unbelievable, this is only one of the four definitions of key employee.

Furthermore, the required look-back rules, especially as applied to pre-TEFRA periods of time, are particularly difficult for plan sponsors to comply with. Records with respect to many of the determinations are non-existent. This attempt to reach back and make the sweep of the top-heavy rules as broad as possible is unnecessary, unjustified, and totally lacking in common sense. This is only one of many examples of overreaching under the top-heavy rules.

As you can see from the illustrations we have provided, TEFRA has added greatly to the complexity surrounding the administration of a retirement plan.

Summary

If the private pension system is a desirable socio-economic institution, it must be able to grow in a healthy manner. Congress and the Administration must step back -- refrain from redoing or reframing the pension law every two years, and allow the multiple changes to be assimilated over a period of time. Otherwise we cannot even determine what impact each successive wave of legislation is having on the pension system.

Pension programs are not adopted for the short term. Careful deliberations are involved in choosing and installing such a system. It is put there to stay; therefore, it must be able to rely on some basic government policies rather than be threatened with extinction by each new class of legislators. It is a wonder how anyone can install a defined benefit pension plan in today's political climate.

Today we are being asked to express our views on the impact of TEFRA after it has been enacted. If we are to have a coherent and workable pension policy, we must air the issues before enactment and come to grips with the pitfalls of new legislation.

On the policy issues themselves, we would urge you to consider the following fact and question. According to the EBRI, in 1979 just over 26 percent of employees in firms of under 25 employees were covered by a qualified plan as compared to over 91 percent of employees in firms with more than 1,000 employees. What incentives can Congress provide to encourage sponsorship of plans for these small entity employees? Complexity and confusion are not incentives. Nor are increased legislative and regulatory requirements.

We appreciate this opportunity to provide you with our views, and we hope that we will proceed together in the future in the common goal of strengthening the private pension system.

Thank you.

STATEMENT OF WALTER HOLAN, PRESIDENT, PROFIT SHARING COUNCIL OF AMERICA, WASHINGTON, D.C.

Senator CHAFEE. Mr. Holan.

Mr. HOLAN. My name is Walter Holan, and I am president of the Profit Sharing Council of America, which is headquartered in Chicago. Since I am not a lawyer and I, too, have problems figuring out the topheavy plan rules, especially for combined plans, I'm accompanied by David A. Hildebrandt of the Washington law firm of Lee, Toomey & Kent, attorneys for the council.

We are a nonprofit association of approximately 1,300 employers who maintain profit-sharing plans. These plans cover about 1,750,000 employees. Our members are located throughout the United States and engage in practically all areas of economic activities. They range in size from Fortune 500 sized companies down to very small businesses. Roughly, half of our members have less than 100 employees, and a third have less than 50 employees.

We've always been concerned with the orderly and reasonable regulation of profit-sharing plans by the Federal Government. We wish to thank the committee for allowing us to testify on the effect of TEFRA. We are particularly concerned because TEFRA was enacted without our having an opportunity to comment on many of its far-reaching provisions. We estimate there are approximately 17 million employee participants in over 315,000 deferred profit-sharing trust holding over $75 billion in assets which are invested on behalf of participants. Every one of these plans will be affected by TEFRA.

TEFRA purported to effect tax reform. But it will, when fully effective, materially change the ground rules affecting millions of employees and thousands of plan administrators. Profit-sharing plans provide a primary source of retirement income for employees, and create an incentive for increased productivity, capital formation, and shared profits. Some members of the council have had such plans for more than half a century, predating both ERISA and even social security. The council submits that the time has come for Congress to call a halt to further restrictive regulations of qualified profit-sharing plans. Any restrictive legislation should focus only on those plans which are perceived to be abusive.

Specifically, there are four provisions of TEFRA which we feel will be particularly troublesome.

First, the so-called topheavy rules under section 416. We recently published a 5-page article in a magazine telling administrators how to check out their plan to comply with these rules when they have defined benefit and defined contribution plans. This is part of the complexity we have run into.

According to the conference report at the time this was passed, these additional qualification requirements are provided for plans which primarily benefit an employers' key employees. We've heard no discussion on when does a plan primarily benefit a key employee. Moreover, the definition of key employee was written in such a way that the group of key employees will constantly fluctuate as employees are promoted, terminate employment, die or retire. A change in management or the hiring of another group of employees may dictate the application of the additional qualification requirements.

These new rules were superimposed on the preexisting provisions of the code and ERISA, which prescribe in detail rules for determining eligibility, vesting, and many other features. Moreover, these rules have always prohibited discrimination in favor of officers and highly paid employees. The council submits that these preexisting rules have been sufficient for the vast majority of plans.

Under the proposed regulations issued by the IRS last month, section 416 will require every profit-sharing plan to incorporate the topheavy rules regardless of whether or not they will be applicable. This means added legal costs for drafting the complex amendments. The administrative burden will not end there by any means, for the plan administrator will have to test the plan periodically to determine whether or not it is topheavy. If the test is not met, an entirely new set of plan provisions would take over. The plan provisions would thus fluctuate from time to time, depending upon the makeup of the participants and their accrued benefits.

The administrative cost of simply finding out whether or not a plan is topheavy will present an economic burden greater than any perceived benefit to be derived from the application of the topheavy rules. If there are abuses which must be corrected, they should be clearly defined. And then legislation enacted to correct them without requiring the entire universe of qualified plans to undergo unnecessary expense and analysis.

Further, many types of profit-sharing plans allow employees to make voluntary contributions with after tax dollars. This has proven to be a very effective incentive to encourage additional employee savings for their retirement security. In determining the aggregate accounts of key employees, all of these voluntary after tax contributions are taken into account. Thus, a plan is penalized when key employees save with after tax dollars. This inequity should be eliminated.

Second, the new reduced limitation on contributions as set forth in section 415 are not necessary. The ostensible reason for the reduction in the limitations on contributions was to ameliorate abuses in increased tax revenues. The council does not believe that the actual cases of abuse warranted the reduced limitation, or that the reduction in limitations will, in fact, raise any significant additional tax revenues.

In addition, we ask that where there are voluntary contributions in excess of 6 percent of compensation as a contribution to a qualified plan that the portion above 6 percent not be included in computing the annual addition computation.

Third, the council respectfully submits that section 236 which subjects loans to an aggregate cap and a 5-year requirement be eliminated. For example, many of the loans we have found have been for scholarships and home loans. In the scholarship loans, in Chicago, for example, the University of Chicago is charging $10,000 a year for tuition and room and board, and Northwestern is charging roughly $11,000.

Senator CHAFEE. Let me just go back a minute, if I might, Mr. Holan. Back to page 4 where the employee can put in additional savings.

Mr. HOLAN. Yes, sir.

Senator CHAFEE. Those are after tax amounts?

Mr. HOLAN. Right. And they are tax sheltered.

Senator CHAFEE. They are tax shelters while they are there. In other words, it's sort of an unlimited IRA as far as the income goes.

Mr. HOLAN. There's no deduction on it, Senator.

Senator CHAFEE. No. As far as the income goes.

Mr. HOLAN. Oh, as far as the income. Yes, sir.

Senator CHAFEE. That is quite nice for somebody to have. But not everybody gets that.

Mr. HOLAN. That's in the 25-percent limitation.

Senator CHAFEE. Is that limited by the 25 percent?

Mr. HOLAN. Right, sir. You take the employer contributions, forfeitures and either the excess of 6 percent of voluntary contributions or half of the employee contributions to make up that 25-percent ceiling.

Over half of our plans have voluntary savings. A number of the young people save in these plans for specific objectives; not necessarily for retirement. In other words, they will shelter money and they can then withdraw their contribution but not the income for specific purposes. We found, for example, that when voluntary deductible employee contributions were permitted by law that many of the younger people opted for non-deductible contributions so that they could have access to the money at some time.

So in one sense it's a short-term savings device that the employees use. And it's part of the aspect of employers promoting plans to employees as an incentive, which profit sharing has and other plans do not.

Senator CHAFEE. All right. Do you think that the growth of the IRA's will in anyway—the IRA's wouldn't compete with that if the objective of the employee was to have it in there for a specific purpose like a mortgage or tuition. The IRA wouldn't compete on those grounds.

Mr. HOLAN. No, sir. I don't believe it would.

Senator CHAFEE. All right. Thank you. Why don't you keep going?

Mr. HOLAN. Section 242 of TEFRA requires that distributions from qualified retirement plans commence at the later of retirement or attainment of age 70½ and that in most cases distribution be completed by 5 years after the death of the participant and spouse. Mr. Allen touched on this.

Periodic distributions from a plan should be allowed over a period longer than 5 years where both participant and spouse are deceased and distribution is made to dependent parents, siblings, children, and in particular disabled children. For example, if both parents die at 40 and they have a disabled child, the payment should be allowed at least to what would have been the normal retirement period.

To the extent this provision was intended to prevent abuses in the estate taxation of retirement plan benefits, section 245 of

TEFRA, which added a $100,000 exclusion cap to section 2039(g) of the code, suffices.

In summary, it is the council's position that TEFRA's position with respect to topheavy plan rules, maximum contribution limits, restrictions on loans, and distributions after retirement have resulted in administrative burdens and economic costs far and above any revenue gains, tax benefits, or curbing of perceived abuses. Implementation of such far-reaching arbitrary provisions endangers the entire private retirement system.

Employer sponsors set up profit sharing plans as part of a long range program to provide incentives and retirement benefits. Frequent changes in the taxation of qualified profit sharing plans in order to generate additional tax revenue discourages the adoption, continuation and improvement of profit sharing plans.

Senator CHAFEE. Thank you, Mr. Holan.

[The prepared statement of Mr. Holan follows:]

PREPARED STATEMENT OF WALTER HOLAN, PRESIDENT, PROFIT-SHARING COUNCIL OF AMERICA

My name is Walter Holan and I am President of the Profit Sharing Council of America, which is headquartered in Chicago. I am accompanied by David A. Hildebrandt of the Washington law firm of Lee, Toomey & Kent, attorneys for the Council.

The Council is a nonprofit association of approximately 1,300 employers who maintain profit sharing plans. These plans cover about 1,750,000 employees. Council members are located throughout the United States and are engaged in practically all areas of economic activity. Member companies range in size from Fortune 500 size companies down to very small businesses.

The Council has always been concerned with the orderly and reasonable regulation of profit sharing plans by the Federal Government. The Council wishes to thank the Committee for allowing us to testify on the effect of TEFRA on qualified profit sharing plans. We are particularly concerned because TEFRA was enacted without our having the opportunity to comment on many of its far-reaching provisions. The Council estimates there are approximately 17 million employee participants in over 315,000 deferred profit sharing trusts holding over $75 billion in assets which are invested on behalf of the participants. Every one of these plans will be affected by TEFRA.

TEFRA purported to effect tax reform. But it will, when fully effective, materially change the groundrules affecting millions of employees and thousands of plan administrators. Profit sharing plans provide a primary source of retirement income for employees, and create an incentive for increased productivity, capital formation and profits. Some members of the Council have had such plans for more than half a century, predating both ERISA and even Social Security The Council submits that the time has come for Congress to call a halt to further restrictive regulations of qualified profit sharing plans. Any restrictive legislation should focus only on those plans which are perceived to be abusive.

Specifically, there are four provisions of TEFRA which the Council feels will be particularly troublesome:

First, the so-called "top-heavy rules", under Section 416 of the Code, are fraught with untold problems to plan administrators. According to the conference reports, these "additional qualification requirements are provided for plans which primarily benefit an employer's key employees." Little light has been shed on the question of when a plan primarily benefits key employees. Moreover, the definition of "key employee" was written in such a way that the group of key employees will constantly fluctuate as employees are promoted, terminate employment, die or retire. A change in management or the hiring of another group of employees may dictate the application of the additional qualification requirements. These new rules were superimposed on the pre-existing provisions of the Code and ERISA which prescribe in detail rules for determining eligibility, vesting, etc. Moreover, these rules have always prohibited discrimination in favor of officers and highly paid employees. The Council submits that these pre-existing rules have been sufficient for the vast majority of plans.

Under the proposed regulations issued by the Internal Revenue Service last month, Section 416 will require every profit sharing plan to incorporate the top-heavy rules regardless of whether or not they will be applicable. This means added legal costs for drafting the complex amendments. The administrative burden will not end there by any means, for the plan administrator will have to test the plan periodically to determine whether or not it is top-heavy. An entirely new set of plan provisions would take over. The plan provisions would thus fluctuate from time to time, depending upon the makeup of the participants and their accrued benefits. The administrative cost of simply finding out whether or not a plan is top-heavy will present an economic burden greater than any perceived benefit to be derived from the application of the top-heavy rules. If there are abuses which must be corrected, they should be clearly defined and then legislation enacted to correct them without requiring the entire universe of qualified plans to undergo unnecessary expense and analysis.

Further, many types of profit sharing plans allow employees to make voluntary contributions with after-tax dollars. This has proven to be a very effective incentive to encourage additional employee savings for their retirement security. In determining the aggregate accounts of key employees, all of these voluntary after-tax contributions are taken into account. Thus, a plan is penalized when key employees save with after-tax dollars. This inequity should be eliminated.

Second, the new reduced limitation on contributions as set forth in Section 415 are not necessary. The ostensible reason for the reduction in the limitations on contributions was to ameliorate abuses in increased tax revenues. The

Council does not believe that the actual cases of abuse warranted the reduced limitation, or that the reduction in limitations will in fact raise any significant additional tax revenues. TEFRA also eliminated the cost of living increase for three years, until 1986. Recently there have been suggestions that the freeze on the 415 cost of living adjustment be further extended beyond 1985. This suggestion is particularly disturbing to employers.

As indicated above, many plans allow employees to make voluntary contributions with after-tax dollars. However, when an employee contributes more than 6% of compensation as a contribution to a qualified profit sharing plan, some part of the contribution over 6% will count as part of the annual addition limitation. Thus, instead of stimulating private savings for retirement, this provision discourages private savings. The Council urges Congress to remove these voluntary employee contributions from the annual addition computation.

Third, the Council respectfully submits that Section 236 of TEFRA which subjects loans from qualified profit sharing plans to an aggregate cap and a 5 year repayment requirement presents unrealistic curbs on the useful purposes to which such loans are put by participants.

Specifically, the Council feels that both the cap and the 5 year repayment provision should be liberalized with respect to loans for specific worthwhile objectives, such as the purchase of a home, education and major medical expenses. The cost of these "necessities" has been escalating in recent years faster than inflation, and as a practical matter the American dream of a home, an education and good health with which to enjoy them can only be met in many cases through loans from qualified profit sharing plans.

Fourth, Section 242 of TEFRA requires that distributions from qualified retirement plans commence at the later of retirement or attainment of age 70 1/2 and that, in most cases, distribution be completed by 5 years after the death of the participant and spouse. Not only is the language in this section unclear, but the provision hurts rather than helps beneficiaries of qualified retirement plans. For example, in many cases periodic distributions from a plan should be allowed over a period longer than 5 years after both the participant and spouse are deceased and the distributions made to dependent parents, siblings, children and, in particular, disabled children.

To the extent this provision was intended to prevent abuses in the estate taxation of retirement plan benefits, Section 245 of TEFRA which added a $100,000 exclusion cap to Section 2039(g) of the Code suffices.

In summary, it is the Council's position that TEFRA's provisions with respect to top-heavy plan rules, maximum contribution limits, restrictions on loans, and distribution after retirement, have resulted in administrative burdens and economic costs far and above any revenue gains, tax benefits, or curbing of perceived abuses. Implementation of such far-reaching arbitrary provisions endangers the entire private retirement system.

Employer sponsors set up profit sharing plans as part of a long range program to provide incentives and retirement benefits. Frequent changes in the taxation of qualified profit sharing plans in order to generate additional tax revenues discourages the adoption, continuation and improvement of profit sharing plans.

STATEMENT OF STEPHEN H. PALEY, MEMBER OF THE ADVISORY BOARD, SMALL BUSINESS COUNCIL OF AMERICA, INC.

Senator CHAFEE. Now we will hear from Mr. Paley.

Mr. PALEY. Thank you, Mr. Chairman. I am here this morning as a member of the advisory board of the Small Business Council of America. This is a group representing approximately 2,000 small businesses in 49 States. I am also a practicing tax attorney in Chevy Chase, Md., specializing in the representation of the small business.

TEFRA seems, to us, to have one thought running throughout the bill, which is that smallness is bad. And we do not feel that should be the object of a tax bill.

Our research shows that there are approximately 500,000 plans in existence in the United States. Of those plans, somewhere in the neighborhood of 90 percent are small plans, plans with less than 25 participants. And most of those plans are all 100 percent employer funded as opposed to your savings or thrift type of plan. And, finally, if our own experience and that of our fellow counsels are to be properly taken we feel that most of these plans, at least the ones we see, are 100 percent geared off of, I can say, the top employees. That is I think there is an assumption here that I would like to address. An assumption in TEFRA which I think is erroneous.

That if we have these cut-backs in the benefits and the contributions under 415, that the employer is not going to terminate or cut back benefits in the plan. He is merely going to put in the necessary safeguards that are topheavy, and adjust the plan that way.

Representing the small business industry I do not feel this is going to happen. I know you asked Dr. Schieber a question, and he said he did not yet have the facts to answer it. We are starting to see the facts as we are in direct contact as plan designers. What we are seeing is a tremendous, tremendous resistence from our clients, number one, on two situations. They are very, very tired of the on-going cost of amending these plans.

Senator **Chafee**. The on-going what?

Mr. **Paley**. On-going cost of amending these plans and keeping them up to date. From my standpoint, our clients could jokingly call TEFRA and ERISA the lawyer's relief act. Yes, from my personal standpoint it would be wonderful because this can keep me busy for the next 3 years, just amending the approximately 1,200 plans that we handle in our own office.

However, I think we have to address it if we are going to have a viable and strong pension system for the small business. I think we must address this fact. And I see no reason why there should be a difference between the pension for a small business as opposed to a firm such as Textron.

Now we do not feel, as I mentioned, that the small business is going to let its plan sit there and make negative changes that only affect the key employees. I will tell you that my clients have instructed me that if 415 stays in existence that we are going to gear down their plans. Now what does that mean? That means the benefits for the rank and file are going to be reduced proportionately. And I dare say the rank and file can least afford those changes. The top executives in small businesses, through the use of other types of plans—we mentioned unfunded deferred compensation plans today—will find other means to shelter and protect their money. But the $15,000 to $20,000 to $25,000 a year employee, Senator, I do not see how he is going to do it.

Now my clients tell me they are not eleemosynary institutions, and if they cannot have the same benefit on a graded scale, why should their employees? And therefore, I feel—many, many plans, No. 1, are going to be curtailed in their benefits, or, Senator, even more severe, I feel many of my clients will terminate their plans.

Senator **Chafee**. You are saying you think that. Have you seen indications in that direction?

Mr. **Paley**. I have had meetings, and we are having meetings continuously, Senator, with our clients. This is the indication we are given by our clients. For example, one of the meetings I had scheduled before I got sick last week and left the office was with a small business; meeting with the actuary and talking about terminating the plan. And that was a person who was very, very heavy into this pension area, and making very strong contributions for his rank and file employees.

Senator **Chafee**. How small would a company be before a plan is likely to be considered topheavy?

Mr. **Paley**. I don't think there would be a strict number on it. You would hit your 60-percent test, I would say, probably in the teens or twenties, but it could be much more than that. If a plan is structured with certain entry ages and years of service requirement and there has been a heavy turnover, it could be topheavy and it could be larger.

And you are also going to burden companies that will never be topheavy. Even though you may consider them small companies, they will not be topheavy because of the design of their plan. And they are also going to have to go through a very costly amendment situation.

Now what we are addressing ourself to here, Senator, is the impact of the restrictions on the small business, be it in vesting, be it in the faster accumulation of benefits. Now I am not opposed to the minimum benefit requirement of TEFRA. I just am against it where it is applying to a small business but not all businesses.

Thank you. And, Senator, we would like to be able to have more complete remarks put into the record.

Senator CHAFEE. Yes. We will do that.

[The prepared statement of Mr. Paley and additional remarks from Mr. Paley follow:]

PREPARED STATEMENT OF STEPHEN H. PALEY, ESQ., MEMBER OF ADVISORY BOARD, SMALL BUSINESS COUNCIL OF AMERICA, INC.

The Small Business Council of America, Inc. is a national organization representing over 2,000 small businesses located in 49 states. The SBCA is dedicated to preserving the role of small business in America and to making the laws of the country more conducive to the good health of small business. Since its founding in 1979, the SBCA has identified a number of problems for the small business community in the pension area and has sought solutions through the regulatory agencies or the Congress. The organization is committed to creating incentives - and eliminating disincentives - for the establishment and maintenance of pension plans sponsored by small business.

The SBCA strongly believes that TEFRA will substantially weaken the private pension system and may well result in the reduction or elimination of pensions for millions of American workers employed by small businesses.

Statistics regarding the privately sponsored pension system as developed by the OMB reflect that: (1) there are 500,000 qualified plans covering 45 million active participants, (2) 90% of those plans covering in excess of 6-1/2 million participants involve plans with less than 25 people, (3) practically all of these plans are 100% funded by the employer, and (4) most of the plans are designed so that benefits are geared to the top earners' compensation, who are usually owner/employees.

Millions of participants will be adversely affected because the benefits to be derived from, and contributions which may be made to, pension plans sponsored by small businesses have been significantly reduced and because other discriminatory restrictions have been placed up on these plans. It is essential to recognize that all participants in the plan (not only the top earners) will have reduced retirement benefits.

There is an assumption underlying many of the provisions of TEFRA which is clearly erroneous. This assumption is that the owners of a business will not lower the pension benefits of the rank and file employees, even though the owners and other highly compensated employees will have their retirement benefits reduced. The private pension system is the product of government assistance via tax incentives, not the product of altruistic employers. Thus, it should be recognized that instead of TEFRA impacting upon some 180,000 highly paid executives and professionals as claimed by the proponents of this legislation, it will instead impact upon all employees of the private sector whether owners or not.

The private pension system will be weakened by two forces generated by TEFRA. The first, mentioned above, is that except for a few isolated situations, a small business is not going to structure a pension plan which provides larger benefits for its rank and file employees than for its management and owner/employees. As a result, retirement benefits will be cut back across the board, keyed off of the "top" employees, to meet the reduced Internal Revenue Code ("IRC") Section 415 limits of TEFRA on contributions and benefits.

The second negative force produced by TEFRA is aggravated by the present straits of the economy and the weakened state of the small business community. This factor is the immediate cost of amending and submitting plans to the Internal Revenue Service to comply with TEFRA and the ongoing increased administrative expenses caused by the law. Employers simply do not want to spend additional dollars to comply with this new legislation (which is perceived as having a negative impact on the plans) at a time when the earnings of the companies are falling. It is this combination of lower benefits and increased costs which will trigger a series of terminations of private pension plans reminiscent of ERISA. Over one-third of all small pension plans in the private sector terminated in 1974 after ERISA. TEFRA will cause the termination of an equal or greater number particularly because of the discriminatory requirements imposed on small business by IRC Section 416 relating to "top-heavy" plans.

The top-heavy provisions create significant restrictions which, in practice, will apply only to plans maintained by small businesses. The top-heavy rules stand out as a blatant, discriminatory attack on small businesses and their owners.

It seems inconsistent that the President and the Congress have recognized the importance of the role of small business in the American economy and that small business deserves protection, while at the same time TEFRA is aimed at restricting pension benefits for the employees of small business. Substantial assistance is given to the small business community by many governmental agencies through the Federal laws. At the same time, however, Congress has imposed on the pension plans sponsored by the small business community rules which are more restrictive and discriminatory than that applicable to all other businesses in the country. There appears to be an assumption harbored by some members of Congress that small business must be subject to special restrictions because the small company will not treat its employees as well as big business. It is not clear how this perception of inherent "badness" has developed and it deserves consideration as to whether it is founded on reality or upon conjecture. It seems equally (if not more) plausible that small businesses must treat their employees more fairly and provide benefits as good or even better than a large employer since the very livelihood of small business depends on its employees. The President's Commission on Pension Policy[1/] has found that:

> ". . . the rate of pension growth [in the private sector] has slowed significantly. . . . [and that]
>
> the most serious problem facing our retirement system today is the lack of pension coverage among private sector workers . . ."

It is surprising therefore that the very sector which provides millions of needed pensions is now the target of discriminatory and restrictive legislation which will significantly

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[1/] Report of President's Commission on Pension Policy, "Toward a National Retirement Income Policy" (February 26, 1981).

decrease the pension coverage of private sector workers rather than increase it.

Specifically, the new top-heavy rules require that plans maintained by a small business must accelerate vesting of benefits, must provide certain required minimum benefits and must limit the amount of compensation considered for plan purposes. To show the highly discriminatory impact of this legislation, let's compare a hypothetical owner of a small business who is a "key employee" under the new top-heavy rules, with the same hypothetical employee who is now a top executive in a large company.

Vesting: A large employer's pension plan normally requires ten years of employment to obtain a vested right to a pension; the top-heavy rules will generally require the plan sponsored by the small business to fully vest pension rights after a three year period of employment.

Benefit Accrual: If the large employer's pension plan pays a benefit equal to 20 percent of pay, the large employer's plan can credit this 20 percent accrual to employees ratably over their full working career. Thus, an employee who began service at age 25 would earn a pension of one-half percent of pay for each year of service until age 65. Under the TEFRA changes, the small business that maintains a similar 20 percent of pay pension plan would be required to credit the pension at a minimum of two percent per year so that an employee with ten years of employment would be entitled to a full 20 percent of pay pension.

Compensation Limitations: If the executive of the large employer earned $450,000, he could earn a pension of $90,000 under the 20 percent of pay pension plan discussed above. The "key employee" of the small business who also earned $450,000 could earn a pension of only $40,000 because Section 240 of TEFRA will only allow the pension plan to take into account $200,000 in compensation.

Even more abusive is the inconsistency of treatment with respect to early and deferred retirement between key employees of small business and executives of large companies. If a key employee of the small business retired before age 59-1/2 and took his or her pension, a 10% penalty would be imposed. No such penalty is imposed on the executive of the large company who retires before 59-1/2. In addition, if the small businessman wants to keep working past age 70-1/2, he must begin receiving pension benefits at age 70-1/2! Not so for the executive of the large company - he is not required to receive his or her pension benefits until he or she retires.

A draft report to the Council of the Section of Taxation of the American Bar Association by the Employee Benefits Committee on the top-heavy plan provisions of TEFRA states that:

> Unfortunately, certain provisions contained in Section 416 of the Code that cover top-heavy plans will provide greater incentives to terminate rather than establish plans and provide greater retirement benefits for all employees. . . .
>
> We are concerned that the minimum benefit rules, in particular, may lead to the termination of a large

> number of defined benefit pension plans. The rules would require minimum benefits for non-key employees that are more favorable than the benefit accruals presently provided a key employee in many plans.

Interestingly enough, the class of pension plan participants which appears to have the most favored status is federal employees. In 1980, it is alleged that the Federal pension system (which covers only 5% of the work force) paid out more pension dollars than the entire private sector pension system. Needless to say, the top-heavy rules will have no application with respect to the Federal pension system.

Briefly, at a time when there is a strong recognized need for incentives to encourage the adoption and expansion of pension plans by small business, the pension laws imposed on small business are instead becoming more oppressive. At a time when it is almost impossible for an average American worker to adequately save for his own retirement, TEFRA is forcing small employers to terminate plans which would have provided needed retirement benefits. Unfortunately, the reduction of dollars flowing into the private pension system will cause a reduction of a major source of capital in the country. It is widely understood that increased capital formation is necessary for economic recovery.

Specific problems and examples of the negative and discriminatory impact of TEFRA on pension plans sponsored by small businesses are set forth below.

A small company adopted a defined benefit plan on July 30, 1982, effective for the fiscal year commencing August 1, 1981. This defined benefit plan was based upon the law as it stood on July 30th. Contributions were made and appropriate fiscal year end planning was done based upon these legal contributions. The plan was duly submitted to the Internal Revenue Service. TEFRA was, of course, not even close to final passage at that time. In fact, it was not clear whether the law would be passed, let alone what dollar limitations it would contain. TEFRA became law on September 3, 1982. This small business has just been contacted by the Internal Revenue Service and has been told that the plan must be amended to comply with the TEFRA Section 415 limitations. The IRS contends that the plan contributions for the July 31st fiscal year end will have to be reduced and the corporation's tax return will have to be amended to reflect the additional unexpected income. The employer must now decide whether to (i) terminate the plan before it starts, (ii) accept the blatantly unfair retroactive application of the law and its negative impact on this plan, or (iii) challenge the law in Court. This small business will be out of pocket substantial accounting and legal fees because of a law that was not in effect when its fiscal year end closed. If this small business had adopted its plan on June 30, none of the above would have occurred. Retroactive application goes back to July 1, 1982 only!

Another example of the effects of TEFRA on the small business is the following. A family-owned business employing approximately 100 people has sponsored a retirement plan for a number of years. In 1984, when the top-heavy plan rules come into effect, the retirement plan will not be top-heavy, and due to the large number of common law participants is likely never to become top-heavy. Under TEFRA, the retirement plan will have to be substantially amended to include the top-heavy plan provisions and be submitted to the Internal Revenue Service. This will involve substantial cost to the employer and no congressional purpose will be served since the plan in all likelihood will never become top-heavy. Many plans will be subjected to the administrative burden of amendment to include top-heavy provisions, since the proposed regulations provide that only plans which cover only non-key employees who are covered by a collective bargaining agreement are exempted from such provisions.

Section 269A of the Code has created a great deal of distress in the small business community. The reason for this distress can be illustrated by the example of a large law firm in which some of the individual partners have separately incorporated. Pursuant to Section 414(m) of the Code, the Partnership sponsors a retirement plan for its employees which is comparable to the retirement plans sponsored by the individual corporate partners, and the partnership has obtained a favorable determination letter from the Service on its retirement plan. The law firm must now incur substantial expense simply to determine whether its currently approved structure will violate Section 269A. The law firm must then make a decision whether or not to force its partners to disincorporate at potentially great expense, and a decision will have to be made on what to do with the existing retirement plans in order to preserve retirement benefits.

The scope of Section 269A also appears to be overbroad and unfair in its application. A professional athlete who plays a team sport might be subject to the restrictions of Section 269A while a tennis or a golf player or jockey would not. A consultant who performs services primarily for the Defense Department might also be subject to the restrictions of Section 269A. The uncertainty caused by the enactment of Section 269A will undoubtedly cause a great number of small businesses to disincorporate at substantial legal and accounting expense and possibly increased tax cost.

The bias against small business which is inherent in the TEFRA pension provisions is apparent in the provisions imposing a 10% penalty tax on distributions to a key employee who is less than 59-1/2 years of age. No such requirement would apply to an early plan distribution to the president of a Fortune 500 company even though he may very well be earning three or four times what the key employee in a small business may be earning. This provision also discriminates against the professional athlete or entertainment figure whose career may be effectively over at a very early age. Similarly, the TEFRA provisions requiring distributions to key employees to commence at age 70-1/2 also works to the detriment of the small businessman who traditionally works to a very late retirement age.

The limitations on contributions and benefits under TEFRA may actually have the effect of reducing benefits for non-key employees in cases where the new rules cause defined benefit plans to be fully funded. If it appears that no further contributions will be made on behalf of key employees because their benefits are fully funded, then the incentive for terminating the retirement plan will be very great. This, of course, will work to the detriment of the non-key employees. In the case where the benefits are not fully funded under the TEFRA limitations but contributions would be severely limited for several years, termination of the defined benefit plan will also become an attractive alternative in order to avoid the administrative expenses which would necessarily accompany the continued maintenance of the plan.

TEFRA promises to have a very profound effect on the private pension system in America. While many of the goals of Congress in enacting TEFRA were laudable, in particular parity between corporate and noncorporate retirement plans, the effects of many of the provisions will be to cause a large segment of the small business community to either substantially reduce benefits to hard working employees or to entirely opt out of the private pension system. Virtually all small businesses wishing to maintain a qualified plan after 1983 will be forced to incur substantial administrative costs both to amend existing plans and to insure compliance with the new law. TEFRA has an inordinate impact on small businesses which provide pension coverage for a significant number of the plan participants in America. Capital formation through the private pension system stands to be substantially impaired once the full impact of TEFRA begins to be felt. Also, the growing perception that the tax laws are being structured in a manner inimicable to the private pension system and to small business in particular will have a far-reaching impact. Small employers are no longer willing to incur the costs of the constant amendments to the pension plans required by the Congress and the Internal Revenue Service. Substantial numbers of small businesses will terminate plans rather than to bear the cost of this new unduly burdensome and discriminatory legislation.

STATEMENT OF SMALL BUSINESS COUNCIL OF AMERICA, INC.

I. Introduction. The Small Business Council of America, Inc., ("SBCA") which represents over 2,000 small businesses located in 49 states, recommends that Section 240(a) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") be repealed or, in the alternative, that the effective date be delayed for further economic impact studies by the General Accounting Office, the Treasury Department, and the Joint Committee on Taxation. As the Subcommittee is aware, Section 240 of TEFRA added Section 416 to the Internal Revenue Code ("Code"), effective for years beginning after December 31, 1983. Code Section 416(a) generally states that a trust is not a qualified trust entitled to the tax advantages provided by the Code if it is a part of a "top-heavy" plan, unless the plan meets certain requirements.

While SBCA strongly urges the repeal or delay of Code Section 416, we are aware that Chairman Chafee expressed some reluctance to pursue the question of the general discriminatory effects of the top-heavy plan rules in The Effect on Private Pension Plans of Pension Provisions in the Tax Equity and Fiscal Responsibility Act of 1982, Hearings before the Finance Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance, 98th Cong., 1st Sess. (April 11, 1983), hereinafter referred to as TEFRA Hearings. Therefore, this statement also will address certain specific criticisms of the top-heavy plan rules as they currently exist. At the very least, SBCA recommends that Congress substantially revise the top-heavy plan rules, and that Congress delay the implementation of the rules for a reasonable period of time to allow the appropriate agencies to study the economic impact of the rules.

II. Criticisms of the Top-Heavy Plan Concept.

A. In General. SBCA recommends the repeal of Code Section 416 for six important reasons: (1) the top-heavy plan rules represent the first time since the enactment of the Internal Revenue Code that the Code by its express terms openly has discriminated against small employers; (2) the top-heavy plan rules will result in a significant number of plan terminations which will impact adversely on a number of important public policy goals; (3) the top-heavy plan rules significantly increase the administrative cost of maintaining qualified plans of small employers; (4) the top-heavy plan rules encourage employee turnover in small businesses; (5) the top-heavy plan rules will cause small employers to engage in economically counterproductive behavior; and (6) the top-heavy rules encourage employers to explore employee benefits other than qualified deferred compensation plans. The fact that insufficient data has been developed to quantify accurately the six disadvantages listed above suggests, at the very least, that Congress should delay the implementation of the top-heavy rules until the economic impact of these rules can be determined.

B. The Top-Heavy Rules Represent Unjustified Discrimination Against Small Employers. The fact that discrimination against small employers is inherent in the top-heavy rules has been acknowledged by all experts in the pension area, including all of the witnesses who testified at the TEFRA Hearings.

However, these rules are unique additions to the Code in that they are the only major, nonelective provisions of the Code which discriminate between small and large corporations. The top-heavy rules starkly contrast with the Subchapter S rules which generally allow a "small business corporation" to elect to be treated as a partnership. I.R.C. § 1361(b)(1). The Subchapter S rules allow a corporation to obtain the advantage of partnership tax treatment if the owners of the corporation are willing to accept the disadvantages of partnership tax treatment and to absorb the other costs of the election imposed by the Code. See I.R.C. §§ 1362, 1366-68. The Subchapter S rules do not discriminate adversely against large corporations since Congress carefully balanced the advantages and disadvantages of electing Subchapter S treatment. In contrast, the top-heavy rules mandate that small business employers, merely because they are small, endure certain disadvantages of maintaining a qualified plan for their employees without any compensating advantages.

The creation of discrimination between small employer plans and large employer plans also contrasts sharply with TEFRA's goal of eliminating "artifical distinctions" and creating parity between corporate and noncorporate plans. Senate Finance Committee, Press Release No. 83-121 (March 19, 1983). The distinctions which Section 416 creates between large and small employers are as artifical as the former distinctions between corporate and noncorporate plans because large employers and small employers "use pension plans as a method of sheltering income" and allow "excess accumulations of tax-deferred funds by high income individuals," the elimination of both of these acts being goals of TEFRA. Id.

The discrimination against small business inherent in the top-heavy rules is completely unjustified. First, although the top-heavy rules are discussed in the "Revenue Provisions" section of the Conference Commitee report, the short-term revenue gains from all of the TEFRA pension provisions constitute less than 2% of the total revenue gain expected from TEFRA. Most of that gain is expected from the changes made in Section 415 of the Code and not from the top-heavy rules. TEFRA Hearings (Statement of the Association of Private Pension and Welfare Plans, Inc.).

Second, Congress lacks the empirical data to support the assumption that employees benefit less from retirement programs sponsored by small employers than from retirement programs sponsored by large employers. Indeed, according to information supplied to the Subcommittee at the TEFRA Hearings, the retirement plans of eight large oil-related companies only provide for ten-year, cliff-vesting -- hardly generous provisions to find in presumably "benevolent" large employer plans. TEFRA Hearings (Statement of the American Society of Pension Actuaries).

Third, this discriminatory treatment of small employers ignores the fact that the favorable tax treatment afforded to qualified plans by virtue of Section 401(a) of the Code is, in essence, Congress' way of purchasing retirement benefits for rank-and-file employees. Corporate and noncorporate decision-makers, in this case, small business owners, provide benefits for all employees in exchange for the right to defer taxes on their salaries, salaries which would otherwise be taxed at the higher marginal tax rates. Assuming that Congress acknowledges this "purchase" aspect of Code Section 401(a), penalizing a small employer because he takes full advantage of the terms of the purchase is unjustified. Therefore, the top-heavy rules represent unjustified discrimination against small employers and should be repealed or, at least, delayed for further study.

C. The Top-Heavy Rules Will Result in a Significant Number of Qualified Plan Terminations and a Significant Number of Employer Decisions Against Initiating New Qualified Plans, Both of Which Will Impact Adversely Upon Important Social

Goals. Terminations and "no-start" decisions are an economically mandated result of the top-heavy rules because, to the extent that the rules impose significant, additional opportunity costs on small business employers who adopt or maintain qualified retirement plans, those employers who viewed qualified plans as marginally cost/beneficial before TEFRA will terminate existing qualified plans or choose not to initiate new qualified plans after TEFRA.

In the small business context, the owner/employee will be reluctant to structure a retirement plan which provides, in the aggregate, larger benefits for rank-and-file employees than for management employees. As Stephen H. Paley, Esquire, noted in his statement at the TEFRA Hearings on behalf of SBCA, practically all of the plans having less than 25 participants (which constitute ninety percent of the total number of all qualified plans) are designed so that the plan benefits are geared to the top earners' compensation. Those top earners are typically the owner/employees who should be encouraged and not discouraged by tax incentives to provide qualified plans for their lower paid, rank-and-file employees.

Also, the five basic limitations imposed on top-heavy plans by Code Section 416 (compensation limits, vesting requirements, minimum benefits, limits on contributions and benefits, and limitations on distributions to participants) either minimize the advantages of a qualified plan to key employees or increase the costs, that is, the disadvantages, of providing benefits to nonkey employees. Many small business employers, who "shop" for those tax-sheltering mechanisms which have the lowest opportunity costs, will terminate an existing plan or refuse to adopt a new plan (i) to the extent that the limits on benefits to key employees are so restrictive as to make a qualified retirement plan less advantageous than other tax-sheltering alternatives, or (ii) to the extent that the minimum benefit required to be contributed on behalf of nonkey employees causes a plan to be so costly as to be inferior to other tax-sheltering alternatives. Mr. Gerald Facciani, President of the Cleveland-based Professional Plan Administrators, Inc., confirmed that this perception is held by small business owners in his comments appearing in the Christian Science Monitor of November 22, 1982:

> [i]f an owner has the choice of either increasing pension funding for rank-and-file workers by 30% or 40% or terminating the plan, he'll terminate. He has plenty of other tax shelter avenues which he can put his money into. He doesn't have to provide a plan.

Christian Science Monitor, November 1982, p. 135. The top-heavy rules provide an economic incentive to terminate or refuse to initiate new qualified plans in the small business sector.

Persuasive evidence suggests that the number of terminations and "no-start" decisions will be significant. The witnesses who testified at the TEFRA Hearings noted several examples of specific employers who were contemplating or who had decided to terminate or refuse to initiate a qualified retirement plan. E.g., TEFRA Hearings (Statement of the ERISA Industry Committee). In mathematical terms, thirty to forty percent of small plans may be terminated. TEFRA Hearings (Statement of Dr. Silvester J. Schieber, Research Director of the Employee Benefit Research Institute), citing, Grupper, "The Furor Over TEFRA," Institutional Investor (February 1983), pp. 71-80. Information supplied by the South Florida Employee Benefits Council lends credence to this estimate. Its members believe that 900 of the 1,700 plans sponsored by their clients will be terminated after TEFRA becomes fully effective, substantially reducing or eliminating the retirement benefits of 14,000 rank-and-file employees. TEFRA Hearings (Statement of Charles P. Sacher, Esq., Past President of the South Florida Employee Benefits Council).

The prediction that thirty to forty percent of small plans will be terminated is not an outrageous estimate when compared with the significant number of terminations which occurred after Congress adopted the Employee Retirement Income Security Act of 1974 ("ERISA"). A General Accounting Office report issued in 1979 estimated that 18% of the 471,000 pension plans of all types with fewer than 100 participants which existed in mid-1977 were terminated and that ERISA was a major factor in the decision to terminate approximately 41% of the plans. Government Accounting Office, Report to Congress: Effects of the Employee Retirement Income Security Act on Pension Plans with Fewer than

100 Participants 1 (1979). An analysis of determination letters issued by the Service during the relevant period reveals both a dramatic increase in plan terminations after the passage of ERISA through 1977 and a marked decline in the number of new plan qualifications in 1975 and 1976. TEFRA Hearings (Statement of Dr. Silvester J. Schieber, Research Director of EBRI at iii). As Mr. Paley noted in his statement on behalf of SBCA at the TEFRA Hearings, over one-third of all small pension plans in the private sector terminated in 1974 after ERISA. The conclusion that 30 to 40% of all small plans will be terminated as a result of TEFRA is definitely reasonable based on the special sensitivity of small plans to tax law changes, as documented by the ERISA experience, and because the top-heavy rules, unlike ERISA, are primarily aimed at, and overtly discriminatory towards, small employer plans.

Of course, SBCA is not claiming that all plans which are terminated or not started as a result of TEFRA will be terminated or not started because of the top-heavy rules. However, the correct question is not how many plans will be terminated or not adopted as a direct result of the top-heavy rules; rather, the question is how many plans which will be terminated or which will not be started as a result of TEFRA would be retained or started, as the case may be, without the top-heavy rules?

If significant numbers of qualified plans are terminated or if a significant number of small business employers decide not to adopt new qualified plans, several public policy goals will be impacted. First, to the extent that significant numbers of employees, whether key employees or nonkey employees, are deprived of private pension plan benefits after TEFRA, reliance on the already overburdened Social Security system will increase. The top-heavy rules, therefore, will exacerbate what the President's Commission on Pension Policy characterized as the "most serious problem facing our retirement system today," that is, "the lack of pension coverage among private sector workers . . . ." President's Commission on Pension Policy, Toward a National Retirement Income Policy (February 26, 1981). Elimination of small business qualified plans ironically will leave thousands of rank-and-file employees without significant non-social security retirement income, while merely forcing small business owners to find other, yet less socially advantageous, tax-sheltering alternatives.

Second, one perhaps unanticipated result of the top-heavy rules is that small employers will increase their reliance on nonqualified deferred compensation plans. As an example of this phenomenun, interest among tax practitioners is increasing in nonqualified alternatives to qualified plans. See Thirteenth Annual Employee Benefits Institute: Planning Practices After TEFRA, April 21-22, 1983, hereinafter 13th Institute (at which one speaker will discuss "Benefit Equalization and Supplemental Retirement Plans: Undoing TEFRA's

Cutbacks"). Since qualification of a plan generally protects the interest of plan participants, the top-heavy rules are counterproductive to the extent that small business employers substitute nonqualified plans benefitting only their key employees for qualified plans benefitting key and nonkey employees.

Finally, if significant numbers of qualified plans are terminated or not adopted and funded nonqualified plans are not adopted as substitutes, then the amount of capital investment in the economy which is currently provided by retirement plan funds will be partially lost. This result occurs because reserves will not be retained in a funded plan which may be used for capital investment. Even if funded nonqualified plans are adopted for key employees, however, the reserves which would have been maintained and invested to provide benefits for nonkey employees will be lost to the economy.

The amount of lost capital may be enormous since qualified profit sharing plans alone currently hold over $75,000,000,000 in invested assets. TEFRA Hearings (Statement of Walter Holan, President, Profit Sharing Council of America). The South Florida Employee Benefits Council, who estimated that 900 of the 1,700 plans sponsored by its members' clients will be terminated after TEFRA, also estimated that, as a result of the terminations, annual contributions to these plans will be reduced by more than

$40,000,000, representing a large loss of capital formation dollars to the economy. TEFRA Hearings (Statement of Charles P. Sacher, Esq., Past President of the South Florida Employee Benefits Council).

Even admitting that the Council's prediction is based on the total impact of the TEFRA pension provisions and not solely on the impact of the top-heavy rules, the prospect for the loss of capital formation dollars as a result of plan terminations caused by the top-heavy rules is substantial. Obviously, the top-heavy rules will result in significant numbers of harmful plan terminations and "no-start" decisions focused in the small business sector where, compared with the large business sector, fewer employees already are covered by qualified plans.

D. The Top-Heavy Rules, in Conjunction With the Other TEFRA Pension Provisions, Will Cause Significant Administrative Costs to Small Employers Who Maintain Qualified Plans. All plans must include provisions which automatically take effect if the plan becomes a top-heavy plan and which meet the top-heavy plan requirements. I.R.C. § 401(a)(10)(B)(ii); TEFRA § 240(b). Thus, each retirement plan must be amended even if the employer intends to prevent top-heavy status from occurring by permissive aggregation of plans, causing key employees to waive coverage under the plans, or otherwise.

Moreover, the recordkeeping requirements imposed upon employers have been increased significantly since a "key employee" includes any participant who in any time during the plan year or the last four plan years was: an officer, one of the ten employees who owns the largest interest in the employer, a five percent owner of the employer, or a one percent owner of the employer who earned annually more than $150,000 from the employer. I.R.C. § 416(i)(1)(A).

E. The Code Section 416 Rules Will Encourage Rapid Employee Turnover. A top-heavy plan must vest accrued benefits derived from employer contributions according to one of two vesting schedules: (i) three-year, cliff-vesting, in which the benefits of an employee who has three years of service are 100% vested, or (ii) six-year, graded vesting. I.R.C. § 416(b). If a qualified plan otherwise allows an employee to obtain his benefits upon termination of employment, the rapid vesting schedule merely encourages the employee to terminate his employment to obtain his vested retirement benefits and to "move on" and obtain a vested benefit in another plan. Thus, top-heavy plan status may become a key element in an employee's decision of whether or not to join or continue with a small company.

Conversely, if significant numbers of employers decide not to allow distributions upon termination of employment, then Congress inadvertantly has penalized rank-and-file employees by causing them to be unable to obtain their retirement plan benefits prior to retirement, death, disability, or hardship. This result is certain to occur, thereby creating additional administrative costs to the plan, such as recordkeeping and issuing reports to terminated employees who retain account balances.

F. The Top-Heavy Rules Encourage Small Business Employers to Engage in Economically Counterproductive Behavior. For example, the top-heavy plan rules both discourage an employer from promoting an employee to a position as a corporate officer and discourage that same employer from elevating a long-term, rank-and-file employee to ownership status through a stock participation program since, in either case, the employee may become a "key employee" whose accrued benefit or aggregate contributions account will "count against" the employer in a top-heavy plan analysis.

G. The Top-Heavy Rules Encourage Employers to Explore Employee Benefits Other Than Qualified Deferred Compensation Plans. Use of such other benefit programs will allow the employee/owner to shift his or her current medical, quasi-business, or insurance expenses to the corporation, thereby freeing other personal funds for use in his or her private retirement planning. The victim of this anti-top-heavy planning is the rank-and-file employee who cannot control the employer's benefit policy choices and who may not have the resources and sophistication which are necessary to take full advantage of private retirement planning. For example, even with individual retirement accounts, which are being adopted widely today, SBCA believes that future Internal Revenue

Service statistics, like those of past years, will show that only those participants with combined annual family incomes over $50,000 are able to contribute to any significant degree to individual retirement accounts.

H. Conclusions Regarding the Top-Heavy Plan Rules. Considering SBCA's six criticisms of the top-heavy plan concept and the various risks created by application of the top-heavy rules which are discussed above, Congress should postpone the implementation of the top-heavy rules at least until reliable empirical data is generated on the impact of the TEFRA pension provisions. The importance of this delay is easily illustrated. A quick response to SBCA's second criticism of the top-heavy rules, that is, that the rules will cause significant plan terminations, is that no reliable evidence quantifies the number of predicted plan terminations or evaluates the impact of those terminations on national social and economic policy goals. However, this response actually supports our recommendation that Congress delay implementation of the top-heavy rules until further study of their potential impact has been completed since Congress is accountable to the public for the results of Code Section 416 and, as yet, has no empirical data upon which to predict those results.

Because of the six significant disadvantages of the top-heavy plan rules discussed above and the lack of data which presently exists as to the potential impact of the rules, SBCA recommends that Congress repeal the top-heavy plan rules or, at the very least, delay implementation of the rules subject to their substantial revision.

III. Specific Criticisms of the Current Top-Heavy Plan Rules. In response to the Chairman Chafee's request for specific criticisms of the current top-heavy rules at the TEFRA Hearings, SBCA urges that the following provisions of Section 416, in addition to those provisions which were criticized earlier, be repealed or drastically modified.

A. Ownership Interest in the Employer. As noted, a "key employee" means, *inter alia*, any plan participant who at any time in the plan year or the last four plan years was one of the ten employees who owned the largest interest in the employer. I.R.C. § 416(i)(1)(A). One of the proposed regulations recently issued by the Service provides that "[a]n employee who has some ownership interest is considered to be one of the top ten owners unless at least ten other employees own a greater interest than that employee." Prop. Reg. § 1.416-1, T-12. Although this proposed regulation is a reasonable interpretation of this paragraph of Section 416, the regulation leads to absurd results in a case where several equal owners of a business exist.

For example, in a situation which is not untypical, suppose that twenty-five attorneys each own a four percent interest in a law firm. Regardless of the amount of each attorney's compensation and regardless of which attorney or attorneys actually control the operation of the law firm, all of the attorneys are key employees for purposes of the top-heavy rules. Therefore, SBCA recommends that this category of key employees be deleted entirely, especially since, in a small business, employees who are given a minimal amount of stock ownership as a part of a stock compensation program may be considered key employees despite the fact that, in substance, they are rank-and-file employees. Admittedly, the proposed regulations provide that an employee will not be considered to be a top ten owner for a plan year if he or she earns less than the maximum dollar limitation under Code Section 415(c)(1)(A). Prop. Reg. § 1.416-1, T-12. While this exception is commendable, it will not protect against all situations involving the facts which are discussed above since the maximum dollar limitation is drastically reduced by TEFRA.

In addition to the deletion of the "largest interest in the employer" category of key employees, SBCA recommends the deletion of the 5% owner category. The term "key employees" includes both a plan participant owning a greater than 5% interest in the employer and a plan participant owning a greater than 1% interest in the employer whose annual compensation from the employer exceeds $150,000. I.R.C. § 416(i)(1)(A)(ii),(iii). The 5% owner category should be deleted because modestly compensated rank-and-file employees, who TEFRA allegedly intended to protect, may be treated as key employees due to stock participation programs and because the 1% owner test will cover all of the owner-employees against whom Code Section 416 is aimed.

B. Rapid Vesting. As noted, a top-heavy plan must vest accrued benefits derived from employer contributions using either three-year, cliff vesting or six-year, graded vesting. I.R.C. § 416(b). However, the Service only recently was prevented from enforcing vesting schedules more stringent than the 4-40 vesting schedule in Public Law 97-12, Joint Resolution 325, and Joint Resolution 644. Since more rapid vesting of retirement plan benefits probably will have no significant revenue effect and since a more rapid vesting schedule does not apply exclusively to rank-and-file employees, Subsection (b) of Section 416 is an inexplicable reversal of past Congressional policy upon which a significant number of employers have relied in adopting qualified plans.

C. Plans Which Shift Between Top-Heavy and Non-top Heavy Status. Because Section 416 tests top-heaviness based on cumulative accrued benefits and aggregate account balances in defined benefit and defined contribution plans respectively, many plans of middle-sized companies conceivably may shift back and forth between top-heavy and nontop-heavy status from year to year. I.R.C. § 416(g)(1)(A)(i),(ii). This could occur for several reasons.

Since key employees will tend to be officers and owners of the employer and, thus, have a more permanent employment relationship than nonkey employees, a turnover rate for nonkey employees which is higher than the turnover rate for key employees is likely. Even though the group of key employees and the group of nonkey employees accrue the same benefits or receive the same contribution level *each year*, a plan may become top-heavy for the sole reason that the cumulative accrued benefits or accumulated aggregate account balances of key employees continue to increase while the benefits and accounts of the class of nonkey employees decrease due to normal employee turnover. Moreover, in times of recession, those employees who are not officers and owners admittedly are more likely to be discharged or laid off, thereby decreasing the total accrued benefits or aggregate account balances of the group of nonkey employees.

In either case, a plan which is not top-heavy in 1984 may become top-heavy in 1985 solely because of personnel changes not within the employer's control. One commentator has noted, as an alternative to the use of cumulative accrued benefits and aggregate account balances, that top-heavy status could be based on *current-year* accruals in a defined benefit plan and *annual* contributions to a defined contribution plan. Irish and Lent, "Tax Act Changes Rules Governing Top-Heavy Plans," *Legal Times*, October 11, 1982, p. 12.

Moreover, as this commentator noted, the problem of "creeping" top-heavy status may encourage employers to not allow lump-sum distributions. Key employees are not allowed to receive any distributions prior to the date upon which they attain the age of 59-1/2, without payment of a 10% penalty, unless the distributions are made on account of death or disability. I.R.C. § 72(m)(5)(A). Thus, an employer may forbid all lump-sum distributions to all employees prior to normal retirement age so as to retain the accrued benefits or accumulated account balances (as the case may be) of nonkey employees in an effort to prevent top-heavy status from developing.

D. Minimum Benefit Accruals. A top-heavy defined benefit plan must pay an annual retirement benefit derived from employer contributions to nonkey employee participants which at least equals the lesser of (i) two percent of the participant's average compensation per year of service or (ii) twenty percent, multiplied by the employee's average annual compensation during his or her highest consecutive five years. I.R.C. § 416(c)(1); Prop. Reg. § 1.416-1, M-2 through M-5. This requirement materially accelerates the annual accrual percentage required by ERISA and typical in most defined benefit plans.

For example, a defined benefit plan which provides a benefit equal to twenty percent of pay upon normal retirement at age sixty-five will have forty years to accrue the maximum benefit for a twenty-five year-old participant. If the plan is top-heavy, then the twenty percent benefit must be accrued in ten years. Congress has failed to consider that benefit accruals are an employer cost and that the increased cost may simply be too much for many small employers. This rule also results in the odd circumstance of a participant's accrued benefit remaining the same after his or her benefit reaches 20% even though the participant remains an employee for several years thereafter. This result eliminates the incentive for long-term employment and produces the necessity for job shopping.

Moreover, in the top-heavy rules, Congress has now effectively outlawed qualified defined benefit plans which are top-heavy that provide a benefit of less than twenty percent of pay, perhaps preventing a significant number of employers from providing the minimal level of retirement benefit which they and their benefit consultants believe they can afford.

Also, in a recent speech to the 13th Institute, Mr. William E. Lieber, Pension Tax Specialist for the Joint Committee on Taxation, stated that the minimum benefit accrual rules "were a proxy for changes in the integration rules." However, he also noted how surprised several members of the House Ways and Means Committee were to learn from the testimony on H.R. 6410 that a female employee, aged 35 and earning $30,000 a year, could be integrated out of the qualified defined benefit plan of a large national corporation. Unfortunately, the minimum benefit accruals enacted by Congress in TEFRA do not address this problem since a large national corporation may still exclude rank-and-file employees who earn less than the Social Security wage base because such an employer will not be subject to the top-heavy rules of Code Section 416. In this regard, Congress may have hit the mouse when it intended to shoot the elephant.

E. Super Top-Heavy Rules. TEFRA eliminates the "1.4 Rule" for employees who participate in both a defined contribution and defined benefit plan provided by the same employer. TEFRA substitutes a much more complex calculation, the "1.25 Rule," which is further lowered to a "1.0 Rule" for super top-heavy plans. I.R.C. § 416(h)(1). A super top-heavy plan essentially is a plan which would be top-heavy even if a 90% test were substituted for the 60% test used to define top-heavy plans. See I.R.C. § 416(h)(2). Absolutely no justification exists for this added penalty on very small employers and no reasonable justification has been advanced. Thus, even if Congress is unwilling to repeal Code Section 416 in its entirety, the super top-heavy plan rules certainly should be repealed.

IV. Conclusion. The top-heavy plan rules represent a direct and blatantly discriminatory attack by Congress on the retirement plans provided by small businesses. Attacking any specific group of employers or any specific group of corporate employers is not justified; however, penalizing small employers without any evidence of blameworthiness and without a clear understanding of the detrimental effects on the pension benefits of millions of participants in small plans is the true inequity of Code Section 416. The discrimination between large and small employers which Code Section 416 accomplishes is so lacking in rationale and social and economic justification that Congress will be forced to view Code Section 416 as unwarranted discrimination between taxpayers. Therefore, SBCA recommends that Code Section 416 be repealed in its entirety since it represents blatant discrimination against small businesses in the federal income tax laws. As an acceptable but inferior alternative, SBCA recommends that implementation of Section 416 be delayed until substantial revisions can be recommended to Congress based upon empirical data developed in studies by the General Accounting Office, the Treasury Department, and the Joint Committee on Taxation.

Senator **CHAFEE**. It seems to me that what we have here, is that first of all there is no doubt that everybody acknowledges that the TEFRA rules were complex. They ended up this way because we were attempting to get at those plans which had the most likelihood for abuse. It may be you disagree with those goals.

Mr. **PALEY**. No, I don't, Senator.

Senator **CHAFEE**. I am addressing everyone. Everyone can chime in. Do others disagree with the goals? I think somebody said in his testimony, maybe it was Mr. Holan or Mr. Allen, who talked about perceived abuses as though there were not abuses.

Mr. **HOLAN**. Senator, there has never been testimony to my knowledge outlining what these abuses are and to what extent they exist. I have seen some publicity in the newspapers, which I believe was released by the IRS. But for us to address how these abuses can be corrected, we have got to see what they are and how extensive they are. I don't believe, for example, that if you have 1,000 plans in the United States that are abusive out of five hundred and some fifty thousand that it is even necessary to have legislation to correct those abuses.

Senator **CHAFEE**. How do you correct them?

Mr. **HOLAN**. What?

Senator **CHAFEE**. How do you correct the 1,000?

Mr. **HOLAN**. Why correct them? I don't even know what the abuses are so how can I make the suggestion?

Senator **CHAFEE**. Well, in your analogy you said the 1,000 that were abusive.

Mr. **HOLAN**. I'm not sure there are 1,000.

Senator **CHAFEE**. I know. But in other words you acknowledge that abuses can take place under these plans.

Mr. **PALEY**. Senator, we do have an audit procedure through the Internal Revenue Service that should be quite effective.

Senator **CHAFEE**. Such as?

Mr. **PALEY**. In picking up these abuses. You are now having EPPO division in the IRS do nothing but audit plans. The numbers of my clients' plans being audited constantly is probably 5 or 10 percent of total plans I represent, yet not one single plan has been disqualified.

We have searched, as the gentleman next to me said, for these abuses, and we have never been told what they are and how many plans they affect.

Senator **CHAFEE**. I know that we are attempting to change the law because we felt that existing law was too generous to certain top employees. We just didn't think we were not supportive of, say, a $136,000 annual pension when the President retires. Now you can argue with that, but that was the unanimous view of those on this committee.

Mr. **HOLAN**. Senator, why was $30,000 limit in 1974 considered adequate and that same limit was reimposed in 1982 in inflated dollars?

Senator **CHAFEE**. Well, you have got me. I don't know. I wasn't here then. I am here now, though. It seemed to this committee, and I share in it that I am not deferring it onto the committee. I share in this belief that the retirement benefits that were provided under the law were just too generous for some people, and we were not supportive of that. You might disagree. Maybe it's all influenced to a degree by what our retirement benefits are. I don't know.

Those are what we are after. Those are the reasons why we made some of the changes. Anything else?

Mr. **Allen**. Maybe the decision was influenced in part by the notion that higher paid employees receive a pension which is a greater percentage of compensation than rank-and-file. If this is the case, Senator, the Internal Revenue Code, the regulations and all of the rulings are structured around a nondiscriminatory concept, which was alluded to in the fact that this is taken into the audit procedure and which most critically, is tied to the notion that whatever you contribute for a pension for an individual, taken with total compensation, has to be reasonable and a necessary business expense.

It strikes me that if there is a concern over the levels of benefits and contributions that exist, the capability exists in the code and the regs to deal with this, in terms of the reasonableness and the overall nondiscriminatory requirements.

Senator **Chafee**. Well, Mr. Handy said, "Whatever we do, don't fool with the integration provisions."

Mr. **Allen**. I second that.

Senator **Chafee**. Is it not possible to just integrate out the lower paid employees?

Mr. **Allen**. Under the current law that is true.

Senator **Chafee**. Well, you say yes, and Mr. Paley is shaking his head no.

Mr. **Paley**. Not under TEFRA. Not under a topheavy plan you couldn't do it. Under a bigger plan you could.

Senator **Chafee**. Pardon?

Mr. **Paley**. I said under a topheavy plan you could not integrate somebody out. You have minimum benefits and minimum contributions, which are fine. I am all in favor of those, Senator. And I'm not disputing what level of retirement benefits we should have. My point of view is why should we have different levels for small business and large business.

Senator **Chafee**. This is complicated enough without getting that argument into it. You have got a point, but let's go onto the integration part.

Isn't it possible to integrate out the lower paid employees? How about that, Mr. Holan?

Mr. **Holan**. There is very little integration in profit sharing so I pass up any opportunity. Our last study showed——

Senator **Chafee**. Mr. Handy.

Mr. **Handy**. Well, it might well be possible, Senator, but I can't imagine that any large employer has a totally excess plan of R77 or certainly none that integrate out the lower paid employee. I don't know whether that kind of abuse exists or, if so, where.

Senator **Chafee**. Well, thank you all very much. Anything else you want to put in, we will put it in. We appreciate you coming, and we will be calling on you for further help as we go along here.

Thank you.

We will now take a 5 minute break.

[Whereupon, at 11:11 a.m., the hearing was recessed.]

AFTER RECESS

[The hearing was reconvened at 11:18 a.m.]

Senator **CHAFEE**. We will continue. We have Mr. Irish, Mr. Sollee, and Mr. Bush. So why don't you proceed, Mr. Irish?

STATEMENT OF L. E. IRISH, ESQ., CAPLIN & DRYSDALE, WASHINGTON, D.C.

Mr. **IRISH**. Thank you, Senator Chafee. I am Leon Irish, a member of the Washington law firm of Caplin & Drysdale, Chartered. I am a tax lawyer whose principal practice is in the area of employee benefits. I was actively involved in the legislative activity that led to the enactment of TEFRA, and I am here to give you my personal views and comments today. And I hasten to add that those are probably not the views of the generality of my clients, but I would like to share them with you anyway.

I regard TEFRA as a watershed event in employee benefits legislation. I believe that it addresses basic problems and enacted needed reforms. I list five. First, I think there was an extensive problem of what I called the de facto discrimination. Second, I think there clearly were loan abuses. Third, I think plans provided for excessive accumulations. Fourth, I think the plan rules permitted not retirement income provisions, but also the building of estates and death tax avoidance. Fifth, I would list a lack of parity.

For 40 years there has been an uneasy tension between the theory and the practice in the employee benefit area. The basic principle is that the subsidy of the tax laws should not be used to create large pensions for the affluent unless meaningful pensions are also provided for rank and file employees.

In reality, however, skilled and selective use of the rules and the periods during which they are employed has permitted people, particularly high income taxpayers, often in the service industries such as medicine, law, sports and acting, to design plans that would provide primarily for themselves and nothing for the rank and file. Plans in other words constituted nothing more than money stuffers for the rich. These taxpayers were able to shelter large amounts of income from current taxation, often in excess of $100,000 or more a year without providing any vested benefits for rank and file employees.

These same taxpayers might then borrow the money back, pay interest to themselves, and write it off on their tax return.

Quite apart from any revenue considerations, money stuffer pension plans like this flouted in practice the theory of the pension laws, and fueled the common perception that the tax laws permit manipulation by the rich for their own disproportionate advantage.

There was also the subsidiary question of reasonable limits on accumulations in plans. The limit said on benefits and contributions in ERISA could legitimately be thought to be excessive, but they set relatively high dollar amounts, allowed for full indexing on the CPI, and permitted additional benefits for employees covered by both defined benefit and defined contribution plans.

On the estate side, there was an unlimited exclusion from the Federal estate tax laws, and inadequate rules requiring current payout to retired employees. The result of that was that qualified plans had become a major vehicle for building multimillion dollar private estates and passing them onto succeeding generations free of the Federal death tax.

Fifth, prior law discriminated systematically and severely against self-employed individuals. I think one of the truly significant accomplishments of TEFRA was that it reversed this policy and established parity for all workers whether they are employees or self-employed. Parity may not have come soon enough, and may not yet be sufficiently complete, but it's one of the signal accomplishments of TEFRA about which this Congress and this committee should be justifiably proud.

TEFRA addressed those five issues and enacted meaningful reforms. The topheavy rules do meaningfully address the problem of de facto discrimination. The 415 limits were significantly cut back. Plan loans were limited to a top of $50,000. The estate tax exclusion was cut back to $100,000, and central parity was achieved.

These changes will bring practice more nearly into accord with theory. I would like to make sure that my views are recorded that I think there are additional important employee benefit issues that deserve this Congress and this committee's attention. The question of extending coverage of the private system is a key issue. Senator Dole has initiated a study aimed at developing information on that issue.

Unlike Mr. Handy, I would encourage this Congress to look at the issue of social security integration cautiously, carefully, and thoroughly. I think it remains an area where there is, in fact, actual and potential de facto discrimination.

Faster vesting, the death gamble and the special problems of women, an issue addressed in Senator Dole's S. 19, are also significant issues.

Further, I think that there should be sensible rules for statutory and nonstatutory fringe benefits, a revision of the plan termination insurance program, and reconsideration of the rules relating to fiduciary responsibility.

The issues that TEFRA addressed were important; the reforms essential. However, the means chosen involve paying a great price in terms of complexity. In the third part of my——

Senator CHAFEE. Mr. Irish, you know that I asked the prior panel about abuses, and they were not aware of abuses or at least couldn't cite any. You have listed five, I believe, which is helpful. You want to amplify on those five? It would be good and useful.

Mr. IRISH. I do say more of it in my written comments. I think the five were serious for the reasons that I enunciate. There was revenue loss, there was accumulations in private plans well beyond the reasonable retirement income needs of the affluent taxpayers who maintain them, and there was a failure to provide significant retirement benefits for rank and file employees of those very same individuals. And I think TEFRA provided meaningful reforms on those three grounds.

Senator CHAFEE. I think also you made a good point about the perception that these plans were very, very useful for the rich to shelter their income or postpone taxation of their income. I think that is important. I didn't mean to cut you off, you have been helpful. Do you have anything you want to add?

Mr. **Irish**. Two short points, if I may. I would like to speak as others have against the complexity of the solution we have received in TEFRA. I brought a computer printout showing what you have to do to compute the compliance for 1 year for one individual with the new 415 limits. This one solves for the defined contribution plan. This one solves for the defined benefit plans.

It seems to me we shouldn't have to go through four pages of computer calculations to solve one individual's retirement benefit problems.

I think also there are a number of provisions of TEFRA which are simply unnecessary. The first on my written testimony is the top 10 owners' rule, which read by the conference report in the proposed regulations could be 100 or 1,000 people. I think that that's a silly rule, and things like that should be trimmed out of the bill.

I also hope we can get some relief from the burden imposed by the statute, and now reflected in the proposed regulations requiring virtually every plan in America to add topheavy rules. I've suggested why that is not necessary.

Beyond that, I would simply like to thank the committee for letting me appear, and say I would be glad to answer any questions or work with the staff on any technical problems.

Senator **Chafee**. Thank you for that offer. We appreciate it.

[The prepared statement of Mr. Irish follows:]

Prepared Statement of Leon E. Irish, Caplin & Drysdale, Chartered

I. INTRODUCTION

Mr. Chairman, I am Leon E. Irish, a member of the Washington, D. C. law firm of Caplin & Drysdale, Chartered. I am a tax lawyer whose practice for some time has been primarily in the area of employee benefits. I am an active participant in many professional organizations concerned with employee benefits, and I speak and write frequently on employee benefits topics. I was actively involved in the legislative activity that led to the enactment of TEFRA.

I am here today to share with you my personal views and comments on the employee benefits provisions of TEFRA. Because I know many of them would probably disagree with my views on these subjects, I should perhaps state that my views are not the views of the generality of my clients. Because of time constraints, my oral comments will summarize the overall policy views set forth in Parts II and IV, and I will cover only a few of the numerous technical points covered in Part III.

II. POLICY -- TEFRA RESOLVED THE LONG-STANDING TENSION BETWEEN PENSION PRINCIPLES AND PENSION REALITIES

For 40 years the tax laws governing qualified employee benefit plans have reflected an uneasy tension between theory and practice. The theory of the pension rules, reflected in the numerous provisions designed to prevent discrimination in favor of officers, shareholders, and highly compensated employees, has been that the subsidy of the tax laws should not be used to create large pensions for the affluent unless meaningful pensions are also provided for rank-and-file employees.

Lack of meaningful pensions for rank-and-file employees in small plans. In reality, however, skilled and selective use of the rules for qualified plans has enabled employers -- especially small employers -- to establish qualified plans that principally, or even exclusively, benefit highly paid employees. As this Committee knows, there were tens of thousands of instances in which high-income taxpayers -- principally those in service fields such as medicine, law, accounting, sports, acting, and so forth -- would design employee benefit plans in such a way, and select the period of years during which to operate them, so that their plans constituted nothing more than "money stuffers" for the rich. These taxpayers were able to shelter large amounts of income from current taxation -- often in excess of $100,000 or more each year -- without providing any vested retirement benefits for rank-and-file employees.

Loan abuses. In many instances these same taxpayers would then "borrow" the money back from the plan and use it for personal or business purposes. They were quite willing to pay the interest on these "loans," for it provided them with another tax deduction, and they were in effect paying the interest to themselves. Quite apart from revenue considerations, these "money stuffer" pension plans flouted in practice the theory of the pension laws that meaningful pensions should be provided for the rank-and-file, and they fueled the common perception that the tax laws permit manipulation by the rich for their own disproportionate advantage.

Excessive accumulations. A subsidiary but related principle of pension law also came into focus in TEFRA. In 1974 ERISA sought to place reasonable limits upon the extent to which any individual could benefit from the use of qualified employee benefit plans. Properly conceived, the social policy of encouraging and enabling working Americans to provide supplemental retirement income for their old age does not extend to the provision of unlimited opportunities for accumulating private capital on a tax-deferred basis. Yet, the limits set on benefits and contributions in ERISA could legitimately be thought to be excessive, for they set relatively high dollar amounts, allowed for full indexing, and permitted additional benefits for employees covered by both defined benefit and defined contribution plans.

Estate building and death tax avoidance. Just as significantly, the declared purpose of the pension laws of encouraging private savings for retirement income purposes was eroded at the distribution end by the unlimited exclusion from federal estate taxes for distributions from qualified plans provided under prior law. Despite rules aimed at requiring payouts during retirement years, qualified plans had become a major vehicle for building multimillion dollar private estates and passing them on to succeeding generations free of federal death taxes.

Lack of parity. In addition to these ways in which pension facts belied pension theory, there was also a major way in which the pension laws defied sound theory. Prior law discriminated systematically and severely against self-employed individuals with respect to qualified retirement plans. Much of the concern that the IRS and Treasury has exhibited over the past fifteen years over the numerous and complex problems raised by "professional incorporation" has been simply and solely the result of the serious discrimination against the self-employed that was built into the Code. One of the truly significant accomplishments of TEFRA was that it reversed this policy and established parity for all workers, whether they are employees or self-employed. Parity may not have come soon enough, and may not yet be sufficiently complete, but it is one of the signal accomplishments of TEFRA about which the Congress and this Committee should feel justifiably proud.

TEFRA reforms. In five significant ways, then, TEFRA resolved the long-standing tension between theory and reality in the taxation of qualified plans. First, TEFRA enacted top-heavy rules that will require minimum vested benefits or contributions for rank-and-file employees in any plan where the preponderance of the benefits are being accumulated for key employees -- a group largely composed of owners and officers. Second, TEFRA substantially cut back on the dollar ceilings on benefits and contributions to qualified plans, provided for a three-year pause in the indexing of those limits, and reduced the extent to which advantages can be derived by combining plans. Third, TEFRA put new limits on loans from plans, basically restricting them to the lesser of $50,000 or half the vested account balance. Fourth, TEFRA restricted the estate tax exclusion to $100,000 per decedent and enacted rules requiring faster distribution to workers and their beneficiaries. Fifth, TEFRA established essential parity for qualified plans for employees and self-employed individuals.

Results -- and remaining issues. These key changes in the tax rules for qualified plans will bring practice more nearly into line with sound tax and retirement income theory. They make the employee benefit provisions of TEFRA a watershed event. TEFRA did not, however, address or resolve other retirement issues of enormous and continuing significance. For example, one key issue involves how to provide coverage under meaningful pension arrangements to the large segment of the work force that is currently not covered. Not only did TEFRA not address this issue, but its probable effect will be to trigger the termination of some plans and retard the growth of others. Senator Dole has recognized the coverage problem in his recent request for a study and analysis of (1) ways to extend the current system of private plans, (2) whether IRA's should be chosen as the best method of filling this gap, or (3) whether something like the minimum universal pension scheme -- MUP's -- ought to be adopted.

Other issues. Turning to other remaining policy issues, TEFRA did not, with relatively minor exceptions, address such problems as social security integration, faster vesting, the death gamble, or the special problems of women under present pension laws. Senator Dole's bill, S.19, would address some of the latter set of issues in a meaningful way, but it is unclear whether or when the other issues will receive Congressional attention. Finally, to any list of important employee benefits issues that deserve Congressional attention must be added the questions of achieving sensible rules for statutory and non-statutory fringe benefits, revision of the plan termination insurance program, and reconsideration of the rules relating to fiduciary responsibility. Neither of these latter sets of rules is working as well as they should, despite the best efforts of the very able agency staffs that administer them, and Congressional consideration is probably overdue.

Summary -- problem of complexity. To summarize, then, TEFRA represents a fundamental Congressional reaffirmation of pension policies of great value and importance. It did not address all of the important issues that should concern the Congress in the area of retirement income and employee benefits policy. Nor did TEFRA address all of the issues with which it does deal well or effectively. To put the matter succinctly, TEFRA sought to solve important problems in a desirable way but at the cost of enormous complexity. Simplification is not a simple matter, as I have sought to make clear elsewhere.[1] However, no knowledgeable observer, however sympathetic, can deny that the employee benefits provisions of TEFRA involve enormous complexity. TEFRA imposes significant burdens on the entire pension community -- every qualified plan in American will need to be reviewed and amended as a result of TEFRA. Change and complexity are themselves policy matters. Congress needs more clearly to weigh the disadvantages inherent in any change in the law against the potential benefits to be achieved. And, whenever changes are enacted -- and more are needed -- simplicity needs to be a goal more firmly and centrally kept in view.

III. TECHNICAL COMMENTS

Inevitably in statutory provisions as numerous and complex as the employee benefits provisions of TEFRA, and especially in the case of laws enacted under the kinds of time pressures involved in TEFRA, there will be numerous technical defects. These will extend beyond the kinds of changes that can normally be dealt with in a technical corrections bill, where mistakes and inadvertent provisions or omissions can be set right. What follows is a list, rather ad hoc and by no means exhaustive or ranked in order of importance, of various problems that should be corrected or reconsidered in the employee benefits provisions of TEFRA. Although the points raised are largely technical, in at least two cases -- involving the loan provisions and section 269A -- the comments stray into the realm of policy.

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[1] L.E.Irish, "What is Simplification?," 5 J. of Pension Planning & Compliance 305 (1979)

A. Section 415

The significant comment that needs to be made in connection with the TEFRA changes in the section 415 limits is that they involve extraordinary complexity. As concrete examples of this, I have with me computer printouts that show the kind of calculations that have to be made in order to determine whether the benefits for a single individual for a single year exceed the section 415 limits. These calculations involve situations in which either a defined benefit plan must give way to a defined contribution plan, or vice versa. Either way the computations are lengthy, complicated, and not free from uncertainty. Although a fair degree of complexity can be tolerated at the plan level, it seems simply unacceptable as a matter of policy for the tax laws to require four pages of computer calculations to determine whether the benefits or contributions for a single individual for a single year meet the standards of the Code.

B. Top-Heavy Plan Rules

1. Top ten owners. Under Code § 416(i)(1)(A)(ii), a participant is a key employee if he is one of the ten employees owning the largest interests in the employer. The Conference Report suggests at page 626, however, that any participant will be a key employee under this test if there are not more than ten others who own larger interests, and the proposed regulations take the same view. Prop. Reg. 1.416-1, Q.& A. T-12.

This approach makes no sense and should be rejected. There are many professional corporations where it is part of the fundamental policy of the organization that each member have one share of stock, no more and no less. These organizations may have over 100 or even 1,000 members. There is simply no plausible way in which it can seriously be contended that there are a thousand people in the top ten. Nor should organizations be required to give some members additional stock or different classes of stock in order to avoid this rule.

The view expressed in the Conference Report and the proposed regulations has little chance of surviving judicial scrutiny, for the statute is quite clear. Ten is ten; it is not a hundred or a thousand. To remove the cloud raised by the Conference Report and the proposed regulations, however, the Committee should act to clarify that no more than ten participants are ever treated as key employees as a result of the top ten rule. Of course, the IRS and Treasury should be given wide latitude in selecting the method of determining which ten are to be treated as key employees when there are ties -- such as taking the first ten in order of compensation. Corrective action on this and similar small but irksome problems in the technical aspects of TEFRA would go a long way to restoring the sense that the public should have that fairness and good sense lie behind the enactment of tax laws.

2. Anti-PC rule for determining who is a key employee. Code § 416(i)(1)(C) provides that the rules of Code § 414(b), (c) & (m) shall not apply for purposes of determining who is a one- or five-percent owner under those definitions of who is a key employee.[2] The principal purpose and effect of this rule appears to be to treat every shareholder of a professional corporation that is part of a partnership of incorporated partners as a key employee, whether he owns one- or five-percent of the larger entity or not. There are no special problems in determining ownership in such an organization, and the pension community has perceived this rule as little more than a gratuitous slap at partnerships of professional corporations. The tax laws should prevent tax abuse and raise revenues fairly, but it is not part of their legitimate function to disadvantage particular forms of organization which are deemed to be undesirable for nontax reasons. Although this rule is relatively minor in the overall scheme of section 416, its presence in the law will perpetrate a continuing impression of lack of even handedness. The Committee should consider deleting this rule.

3. Aggregation and multiemployer plans. If a plan that, standing alone, would be top-heavy is aggregated with another comparable plan and the resulting combination is not top-heavy, neither plan need meet the top-heavy requirements. In some cases a plan for non-union employees will be able to avoid the top-heavy rules through permissive aggregation with a collectively bargained plan. It is not clear, however, how permissive aggregation works in the case of a multiemployer plan. Presumably the aggregation should take into account only that part of the multiemployer plan that covers the employees of the employer whose other plans are being aggregated. Even then, however, it is not clear whether comparability -- which is necessary for permissive aggregation -- should be tested on a contributions basis, a benefits basis, or either, at the option of the employer. The Committee should address this problem and resolve it in the statute.

4. Determination of key employee status. Under Code § 416(g)(1)(A) a plan is top-heavy with respect to any plan year if, as of the determination date, more than 60 percent of the benefits are for key employees. Except in the case of a

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[2] Under the proposed regulations, however, these aggregation rules would be used to determine whether a more than one percent owner has compensation in excess of $150,000. Prop. Reg. § 1.416-1, Q.& A. T-13.

new plan, the determination date is the last day of the preceding plan year. Under Code § 416(i)(1)(A), any participant is a key employee if at any time during the plan year he meets one of the definitions for being a key employee. The proposed regulations take the position that an employee's status as a key employee is based on the plan year containing the determination date. Prop. Reg. § 416-1, Q.& A. T-15. This is a highly desirable reading of the statute, for only under this reading would it be possible to know at the outset of a plan year whether the plan should be treated as a top-heavy plan for that year or not. However, it is also a very unnatural reading of the statute, for a plain reading of Code § 416(i)(1)(A) would require determination of key employee status as of the end of the plan year for which the top heavy rules are to apply, rather than the preceding year, which is the year that includes the determination date. The Committee should consider amending the statute to provide a better statutory basis for the view contained in the proposed regulation.

5. Five-year drag back rule. The apparent purpose of the rule in Code § 416(g)(3) is to stabilize the status of a plan as top-heavy by continuing to count all distributions during the past five years in the determination of top-heaviness, whether those distributions were to individuals who are still participants, still employees, or even still alive. Further, the intention seems to be to drag back distributions during the past five years from a terminated plan that no longer exists in considering whether a new plan established by the employer is top-heavy. It seems clear that the language of Code § 416(g)(3) simply does not have the breadth that is apparently intended for it, and the Committee should consider amending it to reflect these apparent purposes.

6. The beneficiary rule. Code § 416(i)(5) states that "the term 'employee' and 'key employee' includes their beneficiaries." It is apparently the intention to treat a beneficiary who is also an employee or a key employee as an employee or a key employee for however long he has that status in his own right. In addition, it is apparently the intention of this provision that, in the case of a beneficiary who has no status as a key employee other than as the beneficiary of a key employee, such a beneficiary is to be treated as a key employee only for as long as the key employee himself would have been treated as a key employee if he had remained alive and all other facts were the same. Among other things, this would mean that a person who was treated as a key employee only because he was the beneficiary of a key employee with respect to whom a lump sum distribution was made would continue to be a key employee only for five years following that distribution. Although the intention of this rule is partially spelled out in the proposed regulations, Prop. Reg. § 1.416-1, Q.& A., T-8, the Committee should consider spelling out the full intended meaning of this rule in the statute.

7. Simplified employee plans (SEP's). Although Code § 416(i)(6) treats SEP's as defined contribution plans for purposes of Code § 416, and permits employers to use SEP's under the aggregation rules by taking into account aggregate contributions rather than account balances, SEP's are not subject to the minimum contribution requirements of Code § 416. Since an integrated SEP may provide disproportionate contributions for key employees, the Committee should consider applying the top-heavy rules to SEP's. In addition, the Committee should consider amending Code § 219(b)(2) in order to permit SEP contributions to be made up to the $30,000 maximum allowed under Code § 415. Failure to do this in TEFRA was probably an oversight.

8. Top-heavy plan included in non-top-heavy permissive aggregation group. Code § 416(g)(1) exempts from the top-heavy requirements only top-heavy plans that are required to be aggregated with other plans. It was clearly intended, however, that the top-heavy requirements would not apply to a plan that, standing alone, is top-heavy, but which is part of a permissive aggregation group that is not top-heavy. Indeed, the proposed regulations so provide. Prop. Reg. § 1.416-1, Q.& A. T-3. The Committee should consider correcting the statute so that this rule is reflected in the Code.

9. Rollovers and plan-to-plan transfers. Code § 416(g)(4) provides that, except to the extent provided in regulations, rollover contributions and similar transfers initiated by the employee and made after December 31, 1983, are not taken into account by the transferee plan in determining top-heaviness. The Conference Report adds that this rule is not to apply to rollover contributions or transfers between plans of the same employer, but adds that the rollover disregard rule will not apply if the contribution or transfer is made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans. The proposed regulations set out a more fully articulated set of rules dealing with "related" and "unrelated" rollovers and plan-to-plan transfers. Prop. Reg. § 1.416-1, Q.& A. T-23. The Committee should determine what policies are involved in these rollover and transfer rules, and then place the appropriate rules in the statute.

10. Counting employee contributions in determining top-heaviness. Under Code § 416(g)(1)(A) a plan is determined to be top-heavy or not by reference to cumulative accrued benefits or aggregate accounts, whether derived from employer or employee contributions. The Conference Report indicates, however, that accumulated deductible employee contributions (DEC's) are not to be counted in determining top-heaviness, and the proposed regulations echo this view. Prop. Reg. § 1.416-1, Q.& A. T-21. The Committee should consider the appropriate basis for determining top-heaviness. If the vice at which the top-heavy rules is aimed is the provision of tax-subsidized benefits or contributions disproportionately to key employees

without providing minimal benefits for rank-and-file employees, then it would be appropriate to determine top-heaviness only by reference to employer contributions, for employee contributions are fully subjected to tax before they are added to a qualified plan. Although there is a sense in which DEC's are not an integral part of the plan to which they are contributed, this is equally true for after-tax employee contributions, which must be separately accounted for and are always fully nonforfeitable. Both DEC amounts and employee contributions get the advantage of tax-free build up inside the plan, and employee contributions that are less than six percent of compensation, like DEC amounts, do not count for section 415 purposes. If it does not make sense to distinguish between employee contributions and DEC amounts, does it make sense to distinguish between voluntary and mandatory (i.e., matched) employee contributions? It would not seem appropriate under any analysis to fail to take into account salary reduction contributions, for they enter the plan as employer contributions. It is worth noting, though, that DEC's, to which alone the Conference Report and the proposed regulations would give preferred status, receive tax benefits comparable to the deduction allowed for employer contributions, while after-tax employee contributions do not. Whatever rules are intended, they should be placed in the statute.

11. Maximum accruals or contributions that are lower than the statutory minimums. Under Code § 416(c)(2)(B), contributions need to be made for nonkey employees in a top-heavy plan only at the rate which is the lower of the usual statutory minimum (e.g., 3 percent) or the highest rate at which contributions are being made for any key employee. Thus, if an employer freezes a top-heavy defined contribution plan, no contributions have to be made for either key or nonkey employees. However, there is no similar rule for defined benefit plans, with the result that if an employer freezes accruals under a top-heavy defined benefit plan he must continue to accrue minimum benefits for nonkey employees (e.g., 2 percent). This rule in effect makes it impossible to freeze a top-heavy defined benefit plan; the employer is reduced to a choice of continuing accruals, at least for nonkey employees, or a total termination and distribution of plan assets. The Committee should consider whether this is a desirable result. If not, a rule should be adopted calling for accruals under a top-heavy defined benefit plan that are the lesser of the usual statutory rate (e.g., 2 percent) or the highest accrual rate for any key employee.

12. Top-heavy plan amendments. Under Code § 401(a)(10)(B), all qualified plans must contain provisions that meet the requirements of Code § 416, except as provided in regulations. The proposed regulations would exempt fully from this requirement only collectively bargained plans that cover only nonkey employees, and plans, such as those for state

employees, where no employees could be key employees.[3] Prop. Reg. § 1.416-1, Q.& A. T-28.

With respect to other plans, the proposed regulations permit omission of super top-heavy rules "if the defined benefit plan has no participants who are or could be participants in a defined contribution plan of the employer (or vice versa)." Prop. Reg. § 1.416-1, Q.& A. T-26. Since it would seem possible for any employer with either a defined benefit or a defined contribution plan to adopt the other kind of plan for all or some of the same employees, it is not clear that this rule would actually excuse the inclusion of super top-heavy rules in any particular case.

With respect to inclusion of the regular top-heavy rules, the proposed regulations would allow incorporation by reference with respect to the criteria for determining which employees are key employees and how the top-heavy ratio is to be computed. Id. They would not allow incorporation by reference, however, with respect to the actuarial assumptions to be used in a defined benefit plan for determining the present value of accrued benefits, a description of the plans or types of plans that will be aggregated in testing whether the plan is top-heavy, or a definition of the determination date and the applicable valuation date. Further, each plan must specify a vesting schedule that satisfies the Code § 416(b) requirements, and the compensation limit set forth in section 416(d), although the latter may also be incorporated by reference. Finally, each plan that is not exempted from the requirement for including the top-heavy rules must include provisions insuring that any changes in the plan's benefit structure, including vesting schedules resulting from a change in the plan's top-heavy status will not violate section 411(a)(10). Id.

What all this adds up to is that the vast majority of qualified plans will have to be amended to include detailed top-heavy requirements, even though it is a virtual certainty that no benefits provided under sizeable plans will ever become subject to the top-heavy rules. In short, the effect of section 416 as interpreted by the proposed regulations will be to require most substantial plans to be amended to include provisions that will never serve any purpose. This will subject major plan sponsors to onerous costs and burden the IRS with the task of processing tens of thousands of pointless plan amendments. This simply cannot constitute sound policy.

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[3] Since the benefits of top-heavy rules will in no event be extended to bargaining unit employees in a top-heavy plan, it is not apparent why collectively bargained plans that have key employees must contain top-heavy provisions; the aggregation rules, both required and permissive, would work the same for those plans whether they included such provisions or not.

The requirement of Code § 401(a)(10)(B) fulfills one very important policy purpose. If and only if each plan that might become top-heavy contains provisions committing the plan to the provision of the benefits mandated by Code § 416 will participants be adequately protected. Only if the top-heavy rules are in the plan can participants sue under the plan to get the benefits Congress meant to assure them of by the enactment of Code § 416. Also, except for a few circumscribed cases, it is theoretically, if not realistically, possible for virtually any of the benefits in any plan to become the benefits of nonkey employees in a top-heavy plan -- and thus benefits as to which the plan should provide the protections mandated by Code § 416.

However, to accomplish this basic purpose of assuring that participants have adequate trust and contract law rights which they can enforce in court if their plan becomes top-heavy, it is necessary only that plans incorporate section 416 by reference. Any plan sponsor that wishes to spell out in detail how he wishes the top-heavy rules to apply could, of course, do so. If the plan sponsor chose incorporation by reference, however, then every optional provision under the top-heavy rules would be construed against the plan and in favor of the participant. For example, if the plan sponsor did not choose between the vesting schedules permitted under Code § 416(c), the participant would be entitled to full and immediate vesting, rather than six-year graded vesting.

There is no need for a plan to spell out the actuarial assumptions to be used for top-heavy calculations. If the plan sponsor chose incorporation by reference, and the plan became top-heavy, participants could be allowed to claim under either the assumptions used by the plan sponsor for funding or the assumptions then being used by PBGC, whichever was more favorable to participants. There should be no requirement in any event that a plan spell out what aggregation rules are to apply; presumably no well-advised plan sponsor would ever choose to aggregate with fewer plans than is permissible, and it would seem arbitrary to restrict the aggregation privileges of plan sponsors who inadvisedly draft their aggregation provisions too narrowly. Plan sponsors should be given maximum aggregation privileges at all times, and no mandatory plan provision would seem appropriate on this issue.

There is no need to spell out the determination date in the plan; the statute is perfectly clear as to what that date must be. Code § 416(g)(4)(C). The appropriate valuation date can be determined by reference to the way in which the plan is operated, without any need for a special top-heavy valuation date provision in the plan. Independent of special top-heavy rules, it would be appropriate to impose on all plans seeking determination letters for any purpose a requirement that they include a provision that any change in vesting schedules will not violate Code § 411(a)(10).

In short, all that should be required for any plan that is not yet top-heavy is that it include a single provision -- perhaps following boiler-plate language promulgated by the IRS -- that, notwithstanding any other provision of the plan, if the plan should become top-heavy within the meaning of Code § 416, and so long as it remains so, all nonkey employees will receive benefits or contributions in an amount, under such vesting schedules, and according to such procedures and computations as will fully satisfy the requirements of Code § 416.

This is an urgent problem. Unless the Committee undertakes affirmatively and quickly to relieve non-top-heavy plans from the burden of including top-heavy provisions, the paper-work burden on taxpayers and the government will be enormous.

13. Nonforfeitability. The vesting rules of Code § 416(b) are expressed in the standard Code and ERISA language of "nonforfeitability." Code § 411 spells out what is meant by nonforfeitability. Code § 411(a)(3) sets forth four exceptions to the general rule of nonforfeitability -- death, suspension in certain cases of reemployment, certain retroactive amendments, and certain withdrawals of mandatory contributions. The proposed regulations, however, state that only two of these four exceptions are to apply for top-heavy purposes -- the first and third, but not the second or fourth. Prop. Reg. § 1.416-1, Q.& A. V-5. There is no delegated authority in section 416 permitting the IRS to alter the estabished meaning of nonforfeitability. This Committee should decide what is and what is not intended by the term "nonforfeitable" under section 416, and the statute should reflect that decision.

C. Distribution Rules

1. The 70 and 1/2 rule. One of the laudable provisions of TEFRA extends to all qualified plans the requirement that distributions must begin in the later of the year in which the participant attains age 70 and 1/2 or retires and may not extend over a period longer than his life or the joint lives of him and his spouse. This rule, which basically replaces the "fifty percent" rule of prior law, under which it was sufficient if a participant got half of the value of his pension during his life or the joint lives of him and his spouse, goes a long way towards assuring that compensation that receives the tax subsidy of the qualified plan provisions will actually be paid out as retirement income, and not primarily go towards building up an estate.

However, TEFRA added a special rule according to which distributions to a key employee who is a participant in a top-heavy plan must commence when he attains age 70 and 1/2, regardless of whether he continues to work or not. There is no need for this rule, and its presence requires a special fact determination at the time a participant attains age 70 and 1/2.

There will be many cases in which it will not be clear whether a particular person is a key employee, and even more where it will be uncertain whether the plan is top-heavy. A distribution cannot be delayed in any event beyond age 70 and 1/2 unless the participant continues to work. Surely any tax abuse that could possibly be caused by key employees in top-heavy plans who defer commencement of their pensions because they have chosen to work beyond age 70 and 1/2 does not outweigh the cost and burden of having to make the determination in each case whether this special rule applies or not. The Committee should delete this unnecessary rule.

2. Ten percent penalty for distributions before age 59 and 1/2. TEFRA amended Code § 72(m)(5) to impose an additional tax of ten percent upon any amount distributed prior to age 59 and 1/2 which is attributable to contributions on his behalf while he was a key employee in a top-heavy plan.[4] In order to apply this rule, it will be necessary to keep track of when each person is a key employee and the years during which a plan is top-heavy. This would be so even if the plan were in full compliance with the top-heavy rules and thus would ordinarily not make an annual determination of who is a key employee or whether the plan is top-heavy that year or not. Indeed, the proposed regulations are drafted specifically to permit a plan sponsor to avoid making annual calculations as to whether the plan is top-heavy. See Prop. Reg. § 1.416-1, Q.& A. T-29. Further, the evident purpose of the rules that permit distributions from a plan to be disregarded five years after they are made, and that permit an individual who was a key employee to be disregarded entirely after he has ceased to be a key employee for five years, is to simplify the record-keeping that might otherwise be required for top-heavy plans.

However, in order to administer the special ten percent penalty tax for premature distributions to key employees it is necessary to know, for each year of a plan's operation, who the key employees were and whether the plan was top-heavy. The regulations dealing with the ten percent penalty formerly applicable to owner-employees provides some help where records of precise contributions and earnings are inadequate. See Reg. § 1.72-17(e)(1)(iv). However, even a method such as this requires knowing whether or not an individual was an owner-employee during a particular year. It is a much more complex and uncertain matter to know whether a person is a key employee, and especially to know whether a plan is top-heavy. Yet, the penalty tax is applicable only with respect to amounts attributable to contributions for a participant who was a key employee, and then only if the plan was top-heavy during that year.

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[4] By what appears to be an oversight, the language in parentheses at the end of Code § 72(m)(5)(A)(i) still refers to an "owner-employee" rather than a "key employee."

Having sought throughout the development of the top-heavy rules to avoid imposing impossible record-keeping and monitoring burdens on plans, it makes no sense to impose distribution restrictions which involve all of the same burdens. The Committee should consider deleting the ten percent penalty for distributions to key employees, or finding some alternative to it that does not involve impossible recordkeeping and monitoring burdens.

D. Parity

There are a few remaining areas in the retirement income area in which parity has not been achieved. The best analysis and survey of these matters has been done by Thomas D. Terry of San Francisco. I recommend that the Committee study these remaining areas of disparity and eliminate them.

The largest task facing the Committee in the area of parity, however, lies in the area of non-retirement employee benefits. There is no sound policy reason why self-employed individuals should not enjoy the same tax treatment with respect to their earned income that is enjoyed by employees. Yet, the current Code systematically discriminates against the self-employed with respect to most of the special tax treatments provided for employees. This Committee should carefully review this question and extend the parity concept embodied in TEFRA to include these nonretirement benefits.

E. Loans

Although TEFRA rightly focused on plan loans as an area of significant tax abuse, the solution arrived at seems inadequate and inappropriate. First, TEFRA fails to eliminate the rules that permit a participant to pay interet to himself and deduct it on his tax return. Second, the imposition of dollar and year limitations impose inflexible restrictions that are too much in many cases and too little in others. Finally, TEFRA failed to address the serious problems caused by state usury laws, the existing rules according to which loans can trigger plan disqualification and the vestigal prohibited transaction rules for loans to owner-employees.

In correcting the TEFRA loan provisions it should be borne in mind that there is nothing sinister or wrong about plan loans as such. Indeed, for many participants their retirement plan account will often be the only adequate source of cash that is needed to met a particular emergency. The current rules, however, inappropriately encourage loans by failing to remove the undesirable tax incentives for making them. Accordingly, the Committee should consider prohibiting any loan from an individual account or from a plan with only one participant. Such a rule would eliminate the current inducement to particpants to take out loans in order to pay interest to themselves, often at high rates. Once that inducement is eliminated, there would no longer be a need for dollar limits on the amount that may be borrowed, except perhaps for the $10,000 minimum. The $50,000 limit is arbitrary and bears no necessary relationship to what the legitimate borrowing needs of a participant might be. It would still be appropriate, of course, to limit loans to one half of the vested account balance, though here the rule should be tightened up to prohibit taking into account amounts derived from employee contributions, for such amounts can be withdrawn immediately after the loan is made.

There is no need for the special five-year rule on plan loans. Under the prohibited transaction rules no loan may exceed the terms and conditions of an arm's-length loan. If it were thought necessary to clarify what this means, it could be spelled out in the prohibited transaction rules that a loan from a plan must not only be adequately secured and bear a reasonable rate of interest, but that all the terms and conditions of the loan, including the period of the loan and the repayment schedule, must be at least as advantageous to the plan as would the terms and conditions of similar loans available in the market place. This rule would rule out the practice of loans that are never repaid, and most interest-only repayment schedules. It would then be possible to eliminate the confusing special rules added by TEFRA limiting ordinary loans to five years and providing no specific period for loans to construct, reconstruct, or rehabilitate a home. These are good examples of unnecessary rules that complicate the law without serving a useful purpose.

Finally, three other loan problems urgently need to be addressed. There is currently great confusion over whether state usury laws are or are not preempted. Although the Department of Labor has taken the position that they are in a couple of specific cases, the courts may or may not agree. Moreover, where usury is a criminal offense, there is probably no sound argument that such laws are preempted, because of the savings clause in ERISA § 514(b) for state criminal laws. State usury laws reflect a welter of confusing and disparate requirements. The right course of action would be for Congress to amend ERISA § 514(b) to preempt all state usury laws insofar as they apply to loans from an employee benefit plan.

It also seems mistaken to provide, as Code § 401(a)(13) currently does, that a loan that does not meet the qualification standards of Code § 4975 will disqualify the plan. This is surely overkill. To the extent that present excise taxes for loans that are prohibited transactions are measured only with respect to the amount of the interest that is excessive, this is inadequate. The answer, however, lies in an adequate excise tax levied on the borrower, not in plan disqualification.

Finally, the flush language at the end of Code § 4975(d) and ERISA § 408(d) should be amended to delete the provisions which remove loans to owner-employees from the statutory exemption for loans to participants. There is no sound policy for retaining this vestigal language, and the task of achieving parity for retirement plan purposes between employees and self-employed individuals will not have been achieved until it is removed.

F. Section 269A

In the enactment of TEFRA, Congress displayed a keen dislike of partnerships of professional corporations, a dislike that seems to extend beyond tax implications. TEFRA's parity provisions largely eliminated the principal inducements for forming such entities. The enactment of section 269A, however, seems both unnecessary and probably ineffectual. The provision represents a poor marriage of concepts borrowed from quite different sections of the Code -- sections 269 and 482. It creates a mare's nest, both of uncertainty and complexity. Worst of all, it probably does not work in many of the cases in which it might be thought appropriate. Although the IRS has been admirably prompt in issuing proposed regulations under Code § 269A, the positions taken in these regulations, rather than settling matters, may simply state the lines along which litigation will proceed.

Section 269A should be repealed. There should be no special rules aimed at professional corporations or service corporations as such, and *in terrorem* rules like Code § 269A do not serve the tax law well in the long run. The known tax abuses can be adequately dealt with by adding the multiple surtax exemption and the accumulated earnings tax to the list of Code provisions to which the Code § 414(m) definition of a single employer is relevant. If any problems under the dividends received deduction rules are not adequately dealt with by the personal holding company provisions, they could receive similar treatment. The one-shot deferral obtained by establishing a fiscal corporation has been accepted in all other areas and does not involve issues of sufficient magnitude to justify a special rule. In short, the specific tax problems caused by partnerships of incorporated partners should be solved by narrowly tailored provisions. Section 269A, by contrast, represents a blunderbuss approach, and it fittingly shares all of the loud and smoky ineffectuality for which that ancient armament is famous.

IV. CONCLUSION

In enacting the employee benefits provisions of TEFRA, Congress squarely faced and decided basic issues of tax policy. The overall result of these provisions will be to insure that rank-and-file employees receive some minimal retirement benefits under plans that disproportionately benefit key employees.

In TEFRA Congress also established new monetary standards for what will be deemed a reasonable provision for retirement income. TEFRA established the principle of full parity between employed and self-employed individuals. Finally, TEFRA took meaningful steps to preclude the continued use of qualified plans as vehicles for borrowing or building estates and avoiding federal estate taxes.

As I have attempted to point out, the means chosen in TEFRA too often involved excessive complexity. In addition, there are numerous technical defects and flaws that this Committee should address. Finally, there remain vital issues of federal retirement income policy affecting private employee benefit plans that deserve this Committee's attention, and that of the other committees of Congress with responsibility for this area.

I wish to thank the Committee for this opportunity to share my thoughts and views. I would, of course, be delighted to work with the staff to clarify any points that have been raised in my testimony, or to be useful in any other way.

Let me close by saying that this Committee and the Congress are to be applauded for the employee benefits reforms achieved in TEFRA, and encouraged in the pursuit of improvements in these and other laws that affect the vital area of employee benefits. Thank you.

Senator **CHAFEE**. Mr. Sollee.

STATEMENT OF WILLIAM L. SOLLEE, ESQ., IVINS, PHILLIPS & BARKER, WASHINGTON, D.C.

Mr. **SOLLEE**. Thank you, Senator. My name is William Sollee of the Washington, D.C. law firm of Ivins, Phillips & Barker, Chartered. I speak today on behalf of myself and our many large and small corporate and noncorporate clients.

My 16 years of private practice in Washington has focused on a wide range of employee benefit matters. There has been a lot said about the complexity of TEFRA, and I agree with all of that. Certainly, there were many things done in TERFA that made the pension law much more equitable. I agree substantially with the points that Mr. Irish made.

However, I believe there are certain aspects of TEFRA which are inequitable for many rank and file employees, and in that respect should be changed. The 415 limits are certainly quite complex. The early effective date of 415 limits was extremely onerous for many, many employers. The one aspect of the 415 limits I would like to comment on is the cutback of the overall limit from 1.4 to 1.25. This has resulted in the reduction or will result in the reduction of many pensions to the $50,000, $40,000 range for highly paid executives. Now, that may be fine, but it results in some very, very radical cutbacks. And the limited period of time given to try to plan around those cutbacks is unfortunate.

Senator CHAFEE. Let me ask you this. Everybody is complaining about 415, yet that is what the committee wanted. So my question to you is: Taking the goal of the committee, is it possible to achieve them with a good deal less complexity than we have done, or are you arguing with the goals of the committee?

Mr. SOLLEE. I'm not arguing with the goals of the committee at all. I'm afraid that there isn't much of a way to achieve simplicity in this area. The main burden of complexity is because of the overall limit. When you have employees participating in both a pension and a profit-sharing plan, and the fact that you can't put those two together and have a $30,000 contribution and a $90,000 benefit, that results in having to choose which plan you want to cut back.

Senator CHAFEE. You have always had to choose. Even when we had the other limits you could only go to 1.4.

Mr. SOLLEE. That is correct, Senator.

Senator CHAFEE. What's the difference?

Mr. SOLLEE. This was just a further cutback from 1.4 to——

Senator CHAFEE. I know it's a cutback, but what makes the complexities?

Mr. SOLLEE. The complexity is because of the radical reduction in benefits. I have clients who right now for the last year had an accrued benefit of $136,000. As a result of the change, this year their pension will go from $136,000 to $36,000 in 1 year. So tell somebody that. Tell them that because of 1 year's contribution their benefit would reduce that much. That's incredible. I don't want to belabor the 415 issue, however.

Senator CHAFEE. It's not a message you want to give over the phone. [Laughter.]

Mr. SOLLEE. That's right. And I don't really know if those changes were well thought out. Maybe they were.

Senator CHAFEE. All right. Go ahead.

Mr. SOLLEE. I think the area of greatest inequity to the most participants concerns required distributions under code section 410(a)(9). Under this section, benefits must be paid out over the lifetime of an unmarried participant. The benefits must be paid out within 5 years of death of an unmarried participant. Several have already mentioned this provision. Let me just stress that this is an extremely important change that TEFRA made. There was absolutely no notice that the change was going to be so onerous. There is nothing in the law, existing at the time TEFRA was enacted that would have indicated the Congress would have been so strict with these particular payout limits.

Senator CHAFEE. All right. We have dealt with that quite a bit. Why don't you go to your next one?

Mr. SOLLEE. The estate tax exclusion. My suggestion is because of the complexity of determining whether or not you are entitled to it that the provision be simplified to let everybody with $100,000 or more accrued benefit have an exclusion of $100,000.

Pension withholding. The law, as interpreted, does not allow flat dollar pension withholding. You can elect out of pension withholding. It seems that employers and plan administrators ought to be able to go to participants and say "How much do you want to have withheld on a specific flat dollar amount?"

Parity. I applaud the parity provisions of TEFRA. I urge that Congress eliminate all distinctions in the tax law between employee benefits of corporations and self-employed individuals. I've listed those in my testimony. I realize there are revenue problems with this, and I just urge that if Congress extends the limits on employer exclusion of fringe benefits, for example, the current proposal to limit the exclusion on employer provided medical benefits—if that is done for corporate employees, I urge that self-employed individuals be given the same type of exclusions under the code.

If there is a sincere desire to see professionals operate as self-employed individuals rather than as professional corporations, further actions are needed. The liquidation provisions of TEFRA, section 247, really didn't go far enough. There are very severe, adverse impacts on professionals who want to disincorporate, recapture of investment credit and accelerated depreciation being two.

A lot of professionals will not liquidate if these provisions aren't somehow taken out of the law.

Section 269A was adopted in order to override the *Keller* case. Is this particular provision still needed? I think that the Congress ought to repeal section 269A, and perhaps address the problem specifically. The problem needs to be addressed.

Now the last point I want to make, Senator, with respect to the topheavy provisions—there has been a lot of talk today that the topheavy provisions are antismall business. Well, that may or may not be true. It's not necessarily so. But let me just point out that the tax code is replete with different treatments for small businesses, some of them favorable; some of them unfavorable. And I think in many instances there is a real reason. The subchapter S provisions which Congress just passed are favorable to small business. I don't see small businessmen complaining about that.

The redemption rules in the corporation area are antismall business. If you are a small businessman, you can't have stock redeemed without having severe adverse tax consequences. That isn't true for large businesses. So I would say that it is not necessarily bad that the topheavy rules get at some of the perceived abuses. And I agree with Mr. Irish here. There certainly were actual abuses in practice in the topheavy area, and the topheavy rules address those. Certainly the topheavy rules should not be extended, though, to all plans, all plans above a certain level. I've made a suggestion that perhaps employers with more than 500 employees shouldn't have to have to comply with the topheavy rules, or 100, or whatever number you want to select.

Senator **Chafee**. All right, Mr. Sollee.

Mr. **Sollee**. Yes, sir.

[The prepared statement of Mr. Sollee follows:]

PREPARED STATEMENT OF WILLIAM L. SOLLEE, MEMBER, IVINS, PHILLIPS & BARKER, CHARTERED

I am William L. Sollee, a member of the Washington, D. C. law firm of Ivins, Phillips & Barker, Chartered. I speak today on behalf of myself and our many large and small corporate and noncorporate clients who maintain various types of pension plans for their employees. My 16 years of practice have been primarily involved with a wide range of employee benefits matters.

I appreciate the opportunity to appear before you today to comment on the impact of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") on private pension plans. My purpose here is to discuss some of the practical problems and impact TEFRA has had on the pension plans of our clients.

TEFRA was a very broad tax bill, particularly as it impacts qualified pension plans. Every pension plan maintained by our clients must be amended in one or more ways because of TEFRA. Perhaps some of these changes will provide additional protections and benefits for rank and file employees. On the other hand, it is clear that several of the TEFRA changes will have adverse affects on the pension rights of employees.

Before I make my specific comments, let me say that if there is to be additional major pension legislation, please give the public full and fair opportunity to study the impact of all of the proposed changes. Too often there are general proposals for changes which by the time enacted into law do not in any way, shape or form resemble the proposals. Some of the TEFRA items fall into this category.

Limits on Contributions and Benefits - Section 415.

TEFRA's changes in the limits on contributions and benefits under qualified plans have been exceedingly complex and hard to deal with. During the last several months, particularly the last few months of 1982, I have spent more time in my practice in advising clients on how to deal with the new provisions on limits than on any other single issue. This was due to the early effective date of the section 415 changes and the need for some employers to adopt detailed and comprehensive changes in the limitation provisions before 1983. In the future, if Congress legislates a change potentially affecting accrued benefits it is suggested that employers be given ample time to make the necessary plan amendments. This was not done by TEFRA.

It seems questionable that the dollar savings obtained by cutting the limits have been worth the effort. Cutting the overall limit on contributions and benefits back from 1.4 to 1.25 has proved particularly complex and onerous. As a result of this cutback, many employers are having to consider establishing excess benefit defined benefit and defined contribution plans. This will have the impact of reversing the ERISA funding requirements. Instead of increasing the funding level of pension plans, as ERISA was designed to do, this aspect of TEFRA has resulted in the decrease of the funding of pension benefits.

Another adverse aspect of the TEFRA changes in the section 415 limits is that anticipated cost of living adjustments to the overall benefit limits may not be taken into account. This will result in employers having to fund pension benefits on a terminal basis. It is urged that, at a minimum, there be no further efforts to freeze the cost of living provisions of section 415.

TEFRA amended Code section 415(d) to suspend COLA's in the limitation amounts until 1986, at which time adjustments will resume in accordance with regulations to be prescribed which "shall provide for adjustment procedures which are similar to the procedures used to adjust benefit amounts under section 215(i)(2)(A) of the Social Security Act". The Senate Finance Committee Report on TEFRA states that these adjustments will be "measured by the formula then in effect to provide cost of living increases in Social Security benefits". 1 S.Rep. No. 494, 97th Cong., 2d Sess. 315 (1982). At the time TEFRA was enacted many believed that Congress would change Social Security COLA's to follow the increase in average wages rather than the consumer price index.

The Social Security Amendments of 1983, H.R. 1900, which was recently passed by Congress, continues to apply a CPI measure in calculating COLA's for Social Security benefit purposes, but includes a so-called "stabilizer" whereby a wage increase measure will be substituted during periods when the amount in the OASDI trust fund is below a designated percentage of expected annual benefit payments. Since the funding level of Social Security is irrelevant to private qualified plans, it would seem that a CPI measure should be applied under Code section 415(d) for 1986 and thereafter regardless of whether the "stabilizer" takes effect for Social Security COLA purposes. However, it may be that regulations will attempt to apply the Finance Committee report literally and adjust private COLA's to a wage index if Social Security COLA's are so adjusted. This would be complicated, because the new law also applies a catch-up rule that makes up for withheld CPI COLAs if the fund attains a specified level of healthiness.

Required Distributions - Code Section 401(a)(9).

TEFRA contains some particularly unfair provisions dealing with the distribution of benefits. Under revised Code section 401(a)(9), lifetime distributions to an unmarried participant must be over a period no longer than the participant's life expectancy. (Presumably it will be permissible for the participant's life expectancy to be recalculated each year as with the present H.R. 10 rules (but contrary to the IRA rules) so that a participant who outlives his original life expectancy will continue to receive benefits over his lifetime.) In addition, under the revised section 401(a)(9) post-death distributions to a nonspouse beneficiary must be made within five years of the participant's death. In other words, if an unmarried participant retires and, before receiving all of his benefits from the plan he dies, the remaining portion of his plan benefits must in all cases be distributed within five years of his death. It is not even permissible for the plan to purchase an annuity contract and distribute that contract to the participant's beneficiary.

It will now be impossible for an unmarried participant to elect a joint and survivor benefit with a beneficiary other than a spouse. For example, a participant will not be able to provide a survivor benefit to his children, his brothers, or sisters, his parents, etc., even if his intended beneficiary is ill and unable to take care of himself. Is it socially undesirable for a participant to divide his benefit in such a way so as to provide a lifetime income to a sick aunt? Present law would permit a participant to select a beneficiary other than his spouse, as long as the payout of his benefits complied with the incidental death benefits test. Since the estate tax exclusion has been limited to $100,000, and because of the restraining effect of the incidental death benefits rule, it seems quite proper to permit a participant to select a nonspouse beneficiary. It also seems proper to permit a benefit to be distributed to a beneficiary either in installments or through the purchase of an annuity contract, in both cases the payments being over the life of the beneficiary and not limited to five years after the participant's death.

These TEFRA distribution provisions were a carryover of some of the distribution rules governing H.R. 10 plans and IRAs but in certain respects the new rules are even tougher. The first time the public saw these rules was in the final Conference Report on TEFRA so at no time did anyone have a chance to offer comment on their appropriateness. Quite simply, the onerous aspects of the new rules should be revised before they become effective.

Estate Tax Exclusion - Code Section 2039.

TEFRA placed a $100,000 aggregate limit on the estate tax exclusion for certain retirement benefits payable under qualified pension plans, tax sheltered annuities, individual retirement accounts, annuities, or bonds. However, no amount included in a lump sum distribution payable under a qualified plan is eligible for the $100,000 exclusion unless the beneficiary irrevocably elects to treat the distribution as taxable without regard to the capital gain and ten-year income averaging rules generally applicable to lump sum distributions. Similarly, amounts payable from an IRA are eligible for the exclusion only to the extent such amounts are payable as a qualifying annuity.

As a matter of simplicity, it is suggested that the special rules requiring election out of lump sum distribution treatment or payment in the form of a qualified annuity where an IRA is concerned be repealed. Complex planning and drafting problems are created by the necessity of planning to take advantage of the $100,000 exclusion, and the necessary competent advice in this issue is rarely available except to the wealthiest recipients. Since the exclusion has been limited to a relatively small amount, it would seem equitable to eliminate, as a trap for the unwary, the restrictions with respect to the availability of the exclusion and to allow the exclusion in all cases for an aggregate of $100,000 of qualified plan or IRA benefits.

Withholding on Pensions - Code Section 3405.

TEFRA instituted a system requiring withholding on the payment of pensions, annuities and other deferred compensation. The withholding system is elective, as recipients are able to elect not to have any amount withheld from any type of pension payment. Despite this, the law has been interpreted as not permitting a payee to designate a specified dollar amount to be withheld in lieu of wage withholding. If pension withholding could be on a flat dollar basis, it would be most beneficial for payees and plan administrators. The explanation of pension withholding to payees has been quite complicated and has caused much confusion. Some of this confusion could be obviated if plan administrators could inform payees that, in addition to being able to elect out of pension withholding, the payee could designate the dollar amount to be withheld. The utilization of the regular wage withholding system for periodic payments does not make much sense when it comes to pension withnolding.

Parity.

The pension parity provisions of TEFRA are to be applauded. The elimination of most of the distinctions in the tax law between qualified plans of corporations and those of self-employeed individuals has done much to rectify the many years of disparate treatment. However, in addition to certain residual areas of pension disparity, there are many other areas still remaining where there is not yet parity in treatment in terms of employee benefits of corporate employees and self-employed individuals. It is urged that Congress eliminate all distinctions in the tax law between employee benefits of corporations and those of self-employeed individuals.

Specifically, self-employed individuals should be entitled to the same tax treatment as employees with respect to group term life insurance under section 79, accident and health plans under sections 105 and 106, employee death benefits under section 101, meals and lodging furnished for the convenience of the employer under section 119 and qualified transportation expenses under section 124.

I am not in a position to state the revenue impact of this type of parity. At this time I recognize that additional parity would as a practical matter have to be revenue neutral.

However, to the extent Congress places limits on the exclusion of employer-provided fringe benefits for corporate employees, the benefit of such fringe benefits should be extended to self-employed individuals. For example, if the Administration's proposed caps on the exclusion of employer-provided medical care are adopted, the medical care provisions of sections 105 and 106 should be extended to self-employed individuals.

If there is a sincere desire to see professionals operate as self-employed individuals rather than as professional service corporations, additional actions must be taken. First, the liquidation provisions of TEFRA section 247 need to be expanded. Under the law in its present form, many professional corporations cannot be liquidated without precipitating significant adverse tax liabilities because of the recapture of investment credit and accelerated depreciation. While section 247 of TEFRA provides some safeguards, it does not go far enough.

In addition, Congress should reexamine Code section 269A, which was enacted as part of TEFRA in order to overturn the results reached in cases like Keller v. Commissioner, 77 T.C. 1014 (1981), on appeal. Because of the pension parity provisions, section 269A has lost much of its usefulness. There are to be sure other benefits to be gained from incorporation, as discussed above. However, if anyone is inclined to operate in corporate form to take advantage of such benefits, section 269A will not operate as much of a hindrance. A close reading of section 269A indicates that it may be relatively easy to plan around. For example, before section 269A is applicable, the principal purpose for forming or availing of a personal service corporation must be the avoidance or evasion of federal income tax. The Service has found it quite difficult to prevail under section 269 which likewise has a principal purpose test. More fundamentally, section 269A requires that before it is applicable sub- stantially all of the service of a personal service corporation must be performed for or on behalf of one other corporation, partnership or other entity. By the mere splitting up of the one entity into two or more entities, one of the prerequisites for the applicability of section 269A has been eliminated.

Rather than engaging in years of wasteful litigation, which Section 269A will probably generate, it would seem preferable for Congress to attack the problem head on. Section 269A should be repealed and replaced with a provision which deals directly with the abuses which Congress believes should not be allowed to continue.

Top-Heavy Plans - Code Section 416.

The provisions of section 416 are exceedingly complicated and in many instances difficult if not impossible to apply. There are some provisions which are more onerous and inequitable than others. I will not spend the time to detail all of the problems, but I would like to point out some of the specific inequities that should be addressed immediately.

1. Top-Heavy Provisions Required to be in Essentially All Plans. Section 401(a)(10)(B) provides that, except to the extent provided in regulations, a plan whether or not top heavy is qualified only if it contains provisions which will take effect if the plan becomes top heavy and which meet the requirements of section 416. It was assumed, based on the legislative history, that the Service would issue regulations which would exclude large plans from this provision. However, in recently proposed regulations, the Service has essentially required that all plans, no matter how large and how unlikely that such plans would become top heavy, contain all of the top-heavy rules. This will be exceedingly burdensome and unnecessary in the case of large plans. For example, the Service could exclude from this requirement plans where benefits and account balances for key employees are less than 50 percent of benefits and account balances for all employees. Also, the plan could provide that any part of the plan which is spun off or merged into another plan would have to contain the top-heavy rules unless the 50 percent rule were met by the successor plan. In any event, it is clear that the vast majority of large plans will never have to comply with the top-heavy rules so it seems silly to require such plans to include 15 - 20 pages of language for an eventuality which will never take

place. Furthermore, if such language must be included in the plan, must the employer include an explanation of the top-heavy rules in the summary plan description? Congress should direct the Service to exempt from this requirement all plans which are not likely to become top heavy. Congress should perhaps go farther and exempt all plans with, for example, more than 500 participants from the top-heavy requirements.

2. Distributions Before Age 59-1/2. Under section 72(m)(5) if a distribution is made to a key employee in a top-heavy plan before he attains age 59-1/2 an additional tax is imposed equal to 10 percent of the amount includible in income unless the distribution is made on account of death or disability. This is an unfair requirement. There are many industries in which employees retire before age 59-1/2 and it seems only equitable to permit such employees to receive distributions without penalty from qualified plans. Because someone is a key employee in a top-heavy plan does not mean he should be penalized for receiving benefits before age 59-1/2.

3. Super-Top-Heavy Plans. If a plan is super top heavy, *i.e.*, if more than 90 percent of the benefits and account balances are attributable to key employees, a reduced limit on contributions and benefits applies. This reduced limit is 1.0 as compared to the regular limit under section 415 of 1.25. This super top-heavy plan rule creates unneeded complexity. With all the other restrictions imposed on top-heavy plans by section 416 and other Code provisions, it seems unduly restrictive to also provide for a reduced overall limit for certain plans but not others. It is suggested that the revenue implications of the super top-heavy provisions are negligible and it would be fair and equitable to eliminate this provision.

STATEMENT OF E. PHILIP BUSH, ESQ., TAYLOR & MIZELL, DALLAS, TEX.

Senator **Chafee**. Mr. Bush, we welcome you here. I know that Senator Bentsen was anxious to be here, and if he were here I know that he would be very glad to see you and appreciative of your coming.

Mr. **Bush**. Thank you, Mr. Chairman. I appreciate the opportunity to appear before this subcommittee on such short notice.

Mr. Chairman, my name is Philip Bush and I am with the Dallas law firm of Taylor & Mizell. We represent several hundred small corporate employers who maintain retirement plans.

My practice is limited to the employee benefit plan area, and so I have firsthand knowledge from discussing with a number of clients about their reaction to and the possible effects of TEFRA.

In the summary of my written testimony there are five points that I have covered. The first has to do with the overall benefit limitations set by TEFRA under section 415. We realize that there is concern on the part of the Finance Committee to limit the benefits that are being provided to highly compensated employees. However, we feel that the effect of inflation has not been taken into account. The limitations that were in existence prior to TEFRA, were based on the increases in the cost of living index from the 1975 base of $75,000 for the annual pension benefit limit in defined benefit plans, and the $25,000 limit in annual additions for defined contribution plans.

Based on the new limits and assuming a 5-percent inflation rate for the next 3 years, this will amount to in 1986, stated in terms of 1975 dollars, of an annual benefit limitation of $42,700 for defined benefit plans, and an annual addition limitation of $14,270 for defined contribution plans.

We think that the committee should consider a lesser reduction of the benefit limit than the one that was imposed under TEFRA.

The next four items that I wanted to touch on today are what we believe to be the most onerous provisions in the TEFRA legislation. First of all, as has been mentioned by a number of witnesses today, is the added amendment burden on employers. While we recognize that a number of amendments are unavoidable because of changes in the legislation, we do believe that there may be a way to ease some of the amendment burden for employers. That would be to structure the amendment process in such a way that employers are only required to submit amendments for determination to the Internal Revenue Service after the issuance by the IRS of final regulations. This could be done by permitting employers to incorporate by reference changes in the Tax Code until such time as more specific language is developed by the Internal Revenue Service under final regulations.

As an example, in my written statement I have listed eight different amendments since ERISA in which plans have had to adopt. The frequency of amendments could be avoided, if amendments were not required after temporary regulations being issued, but only upon the issuance of final regulation.

Our firsthand experience on this point is that the Dallas key district office is intending to issue temporary guidelines to employers for amending their plans. We anticipate then that the Internal Revenue Service will issue subsequent, temporary regulations which will require an additional amendment, and then final regulations subsequent to that which would require plans to be amended again.

The next point that I would want to make has to do with the topheavy rules. It's our belief that the topheavy rules create an unfair distinction between employers with a small number of employees and employers who have a large number of employees. The abuses that TEFRA was intended to correct can be accomplished without drawing a distinction between key employees of small businesses and key employees of large businesses. So long as the minimum benefits are required for all nonkey employees under small employer plans, it would result in unfair discrimination against small plans to have highly compensated employees of small plans be subject to lower benefit limitations than highly compensated employees of large corporations.

Senator CHAFEE. All right. Have you finished?

Mr. BUSH. Well, I had two other points that I would like to make. The first is that we also believe that the penalty on distributions to key employees of topheavy plans prior to age 59½ also results in discrimination against small employer plans. It is unfair to allow an equally highly compensated employee of a large corporation to be permitted a distribution prior to 59½ when a key employee of a small business is not permitted that.

We also think that under the plan loan provisions the committee ought to consider extending the transition period for participant loans. From firsthand experience, we know that a number of corporate fiduciaries have routinely required that participant loans from retirement plans be limited to a period of 1 year to allow for a renewal and a pay-down on the original principal amount of the note. This has been primarily to allow for an adjustment of the interest rate. A number of participants have been caught unaware by the TEFRA change, and it seems that a remedial provision could be added to TEFRA to allow for loans maturing in the next 2 years regardless of the loan limits to be renewed for a 5-year period so long as a minimum amount of the loan is repaid at the time of renewal without substantially altering the objectives of TEFRA.

Senator CHAFEE. All right. Thank you very much, Mr. Bush.

[The prepared statement of Mr. Bush follows:]

PREPARED STATEMENT OF E. PHILIP BUSH, ATTORNEY, TAYLOR & MIZELL, DALLAS, TEX.

Introduction

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) had as its avowed purposes the prevention of excess accumulations of tax-deferred funds by high-income individuals, to reduce incentives to use pension plans as a method of sheltering income from tax, and to eliminate artificial distinctions, and to create more parity between corporate and non-corporate pension plans. However, certain provisions in TEFRA have harsh results. In addition, TEFRA itself creates artificial and discriminatory distinctions between large and small plans.

It is our belief that relief from these provisions of TEFRA must be achieved or the result will be to discourage the establishment and/or maintenance of small employer plans.

Severe Drop in Pension Benefits

Two of the purposes of TEFRA were to "prevent excess accumulations of tax-deferred funds by high-income individuals and to reduce incentive to use pension plans as a method of sheltering income from tax". The maximum annual addition to a defined contribution plan had risen from $25,000 in 1975 to $45,575 in 1982 per year. The maximum annual benefit under a defined benefit plan had risen from $75,000 in 1975 to $136,425 in 1982.

This significant increase over a seven (7) year period was apparently perceived as excessive and as resulting in an abuse of the private pension system. However, this ignores the fact that this increase was a direct result of inflation and a rise in the cost-of-living index. In fact, the increases in pension benefit limits was directly tied to the cost-of-living index and increased accordingly each year by the Secretary of the Treasury.

As the Committee is aware, the new $30,000 defined contribution and $90,000 defined benefit limits will remain constant until 1986. Assuming only a 5% inflation factor from now through 1985, the result under TEFRA is to reduce pension benefit limits by 44%. Stated in terms of 1975 dollars, the benefit limits will be reduced in 1986 to $42,700 per year for a defined benefit plan and $14,270 per year for a defined contribution plan.

It is our hope that the Committee would recommend a moderation of the reduction in pension benefit limits. While we recognize the necessity to control pension benefit increases, we believe that the reduction of benefit limits under TEFRA has been too harsh.

Added Burden on Employers

A side effect of TEFRA has been to perpetuate the constant burden on employers to revise and amend their retirement plans. Since the enactment of ERISA, employers whom we represent have had to amend their plans no less than four times. As examples:

1) All Plans had to be amended not later than December 31, 1977 to comply with the temporary ERISA regulations.

2) All Plans had to be amended not later than June 30, 1979 to comply with the majority of the final regulations under ERISA.

3) All Plans had to be amended to comply with the subsequently issued final regulations under §415 dealing with benefit limits.

4) Defined benefit plans have had to amended to provide the basis for determining actuarial equivalence based upon an annoucement in 1979.

5) Most Plans have had to be amended based upon a 1981 Revenue Ruling to require full vesting at normal retirement age rather than normal retirement date, which in most cases is a matter of no more than 30 days difference.

6) All Plans will have to be amended to comply with the new Department of Labor regulations on supervision of benefits.

7) Plans which are members of an affiliated service group have had to be amended to provide credit for hours of service between members of an affiliated service group.

8) All Pension Plans have already had to be amended based upon IRS Announcement 82-19 to avoid accrual of benefits in the 1983 limitation year in excess of the §415 limits under TEFRA.

If the Service follows its prior pattern, plans will have to be amended at least twice for each change under TEFRA. In all probability, three (3) amendments will be required to be made under the §415 changes. This is compounded by the fact that some of the TEFRA changes become effective in 1983 and some in 1984. We have already been contacted by the Dallas Key District Office about their intent to issue temporary amendment guidelines for amending plans under TEFRA.

A great deal of the burden on employers could be relieved were employers permitted to defer submission of amendments for determination to the IRS until the issuance of final regulations. It might be necessary to provide for remedial procedures in some instances. Amendments could be adopted incorporating by reference the changes made by TEFRA until such time as more specific language is developed under the final regulations.

Loan Provisions

It has been our experience that some abuses of the loan provisions in pension plans have occurred in the past. We therefore have no quarrel with the concept of placing limits on the amount of funds which can be borrowed in the future.

However, a large number of plan participants will be unable by August 14, 1983 to repay outstanding participant loans. The changes under TEFRA to the loan provisions were, of course, unexpected. In addition, it has been the practice of many corporate fiduciaries to structure all participant loans on a one-year basis. This is because there have been no guidelines in the past on the period for which funds could be borrowed. Sec. 4975 of the Code simply stated that loans had to be for a stated period of repayment. Neither the DOL nor the IRS has ever issued any rulings or regulations regarding the period for which loans could permissably be borrowed. Many loans have therefore been subject to annual renewal with a partial repayment of principal required by the Trustee in order to renew. These loans, which in many instances were being repaid over a ten (10) year or five (5) year period, cannot be renewed because of the loan limits.

We would strongly urge that a transition rule be provided whereby loans in existence prior to August 13, 1982, maturing in the next twenty-four (24) months, can be renewed for a five (5) year period, regardless of the amount of the loan. This would elminate excessively high loans in an orderly fashion. Otherwise, there will be a tremendous number of loans in default. This puts the participant in the onerous position of being obligated to repay a debt obligation to the plan which he has had to report as taxable income.

Parity in Loan Provisions for Corporate and Non-Corporate Plans

We would point out to the Committee that while IRC §72 was amended to eliminate the provisions which provided that a loan by an owner-employee would be taxable distribution, the prohibited transaction exemption provisions under IRC §4975 pertaining to participant loans still do not apply to loans by owner-employees and shareholder-employees.

If parity was intended as to the participant loan provisions, it will be necessary to revise §4975 and the corresponding labor provisions under ERISA so that owner-employees and shareholder-employees are eligible for the PT exemptions.

Top-Heavy Plans

The apparent objective of the top-heavy rules in IRC §416 is to prevent excessively disproportionate benefits for the highly compensated employees.

However, the imposition of greater benefit restrictions in the case of a plan in which 90% or more of the benefits inure to the benefit of key employees is unwarranted and fails to accomplish anything other than discrimination against the small employer.

Elimination of the distinction between top-heavy plans and other plans as to the benefit limits for key employees would further the objectives of TEFRA rather than hinder them. No key employee of a top-heavy plan can obtain a benefit higher than a key employee of any other plan. In addition, non-key employees are assured of a minimum benefit and an accelerated vesting schedule to their benefits. Compensation of a key employee cannot be taken into account in excess of $200,000. Benefit limits have been drastically reduced overall.

Our experience has been that the benefits of non-key employees in a professional corporation plan and in most small business corporation plans involving highly compensated employees have been significantly higher than the benefits of employees of larger corporations. In fact, we doubt that any of our more than 400 clients will have an increase in the benefits for their lower-paid employees. This is because the benefits which their employees receive are far in excess of the minimum benefit requirements under IRC §416. For this reason, we have not voiced any opposition to the minimum benefit and vesting provisions under §416. In fact, we are in philosophical agreement with the concept of providing a minim~~al~~um plan benefit.

In most instances, a plan will be top-heavy or "super top-heavy", not because the benefits of the lower-paid employees are less than that of employees in general, but rather because of a high ratio of key employees to non-key employees. In addition, many plans which provide more than 40% of aggregate benefits to non-key employees will be top-heavy plans because of the frequent turnover rate of lower paid employees and the longevity of key employees.

Our experience has also been that the rules under §415(e) dealing with combination plans come into play most frequently because of a changeover from one kind of plan to the other and not from employers who maintain both kinds of plans at once. Under the super top-heavy rules, regardless of how long ago the employer maintained the predecessor plan, it will still have the effect of reducing the maximum benefit for key employees in the current plan. We believe that this will also result in a reduction in benefits for non-key employees because a lower contribution percentage or benefit formula will produce the maximum benefit for the key employees in these cases.

Because turnover of non-key employees will result in many plans being top-heavy, employers will be tempted to defer payment of a terminated participant's benefits until normal retirement age. By retaining benefits in the plan, the aggregate account balances or accrued benefits for non-key employees will be a higher percentage of the total.

Under §415(e), a "fresh start" rule is provided for plans which satisfied the 1.4 rule prior to TEFRA. No such fresh start rule exists under the top-heavy rules. Denying key employees of small employers the same fresh start as is provided to equally compensated employees of larger corporations is an unjust discrimination.

The general tenor of the benefit limitations for top-heavy plans is to discriminate in favor of larger employers. A reasonable estimate is that better than 60% of all employee plans cover less than 25 employees per plan. To discriminate against such a large portion of the private pension system would appear to be contrary to the objectives of ERISA.

Penalty for Distribution Prior to Age 59½ for Key Employees of Top-Heavy Plans

The result of this provision is to discriminate in favor of key employees of larger corporations. There would seem to be no logical reason to discriminate against certain key employees primarily due to the size of the employer.

Conclusion

The provisions of TEFRA which are discussed in this statement produce harsh results which are unnecessary to achieve the objectives under TEFRA. A moderation of these provisions would help to achieve parity between small employer plans and large employer plans, as well as remove the provisions of TEFRA which are most likely to discourage the establishment and/or maintenance of small private pension plans.

Senator CHAFEE. Thank you, Mr. Sollee and Mr. Irish, for your testimony. You have all been helpful, and we appreciate you coming.

STATEMENT OF CHARLES N. McLEOD, PRESIDENT AND ACTUARY, NATIONAL ACTUARIAL PENSION SERVICES, INC., HOUSTON, TEX.

Mr. McLEOD. Mr. Chairman, my name is Chuck McLeod, and I am a consulting pension actuary from Houston, Tex. I am representing the American Society of Pension Actuaries, a national organization whose consultants, administrators, and actuaries provide services to approximately 30 percent of all the pension plans in the private sector in the United States today.

Since most of our membership is involved in providing services to small- and medium-size corporate retirement plans, we wish to direct our comments to the topheavy provisions of TEFRA. Our testimony will specifically focus on defined benefit pension plans, which would potentially fall into this topheavy classification.

I would like you to exclude from your thinking the small professional corporations, as the topheavy provisions will have a minimal effect on them. In fact, if professional corporations were the target of the topheavy provisions, the mark was badly missed.

One of the most burdensome and potentially devastating provisions of TEFRA legislation is the minimum benefit which must be provided to nonkey employees in a topheavy defined benefit plan. While the concept of a minimum benefit may have merit, should such a minimum benefit represent a cost which could severely impact the funding of a plan?

Let's take an example. Consider an employee who is 25 years of age, having compensation of $1,000 a month. Let's assume that this individual stays in the employer's topheavy plan for 10 years, that the employer's benefit formula under his company's pension plan is 20 percent of compensation beginning at age 65 and that the employee's compensation does not change for 10 years. The question is, after 10 years, what has this individual accrued? Under the topheavy provisions, this nonkey individual must have accrued $200 per month. The topheavy accrued benefit rules state generally that an individual must accrue 2 percent of compensation for each year of service, maximum 10 years, that the plan is topheavy.

Two hundred dollars is his accrued benefits. What is his benefit projected to be at age 65? Two hundred dollars. Thus, we must accrue his entire normal retirement benefit by the time he is age 35.

Something seems a little bit strange. Where are we going to get the money to pay for this benefit? The only answer is the employer. Should this employee terminate employment, the employer is faced with having to make future contributions for an employee who now no longer even participates in the plan.

What if this company had 200 employees in this classification? What if this individual's salary was $2,000 instead of $1,000 per month? What this accrued benefit at age 35 means is that if a lump-sum distribution is made to a terminating employee under this scenario, we will have given this employee over twice the amount of money we have theoretically accumulated in the plan to fund his benefit at his projected retirement date.

A second area of concern is with the accelerated vesting requirements. In a topheavy plan, an employee must be 100 percent vested after 6 years service. Have we lost sight of the fact that a pension plan is supposed to be a long-term commitment by both the employees and the employer and not a severance pay plan? Are we not now going to give this employee an incentive to leave the company rather than an incentive to stay?

One of the most incredible aspects of the topheavy provisions is the increased administration and recordkeeping requirements. For example, a gentleman previously mentioned the 5-year look back provision. Well, again, what does this mean? It means that each employer must look into his past record for five years to determine who has received distributions from his plan. Whether they be beneficiaries or whether they be participants, they must be classified as nonkey or key. You must take their past distributions into consideration in determining whether or not the plan is topheavy.

What if the records are not available? What is the penalty for not being able to reproduce this information? Will the plan then automatically be classified as topheavy? This seems a rather harsh consequence for requiring records after the fact.

Another problem which was alluded to earlier is the potential recordkeeping requirements of a plan that would switch status back and forth between topheavy and nontopheavy on a year-by-year basis. There are different benefit accrual requirements which could be used. There are different vesting requirements which could be used. What we are saying is potentially we must have two sets of records for each employee, one set while the plan was topheavy and the other while the plan was not topheavy. This is very expensive from the plan administrator's perspective.

Finally, we would recommend delaying the implementation of these provisions for 1, possibly 2, years. An unbiased examination needs to be made to determine whether the tests for topheavy are equitable, whether the accelerated minimum benefits are fair and feasible, and whether the anticipated recordkeeping nightmare is really necessary.

We thank you for this opportunity to express our viewpoints. We sincerely hope that if you do need additional data and input that the American Society of Pension Actuaries will be contacted.

Senator CHAFEE. Thank you. Mr. McLeod.

[The prepared statement of Mr. McLeod follows:]

PREPARED STATEMENT OF CHARLES N. MCLEOD, ON BEHALF OF THE AMERICAN SOCIETY OF PENSION ACTUARIES

The American Society of Pension Actuaries is a national professional society, whose 2,000 members provide actuarial, consulting and administrative services to approximately 30% of the qualified retirement plans in the United States. Since the preponderance of our members provide services primarily to small plans, we will concentrate our testimony on the problems created by, and suggested changes to, the TEFRA top-heavy provisions.

Some of the top-heavy rules most in need of correction are listed below.

1. The 2% minimum per year, maximum 10 years, defined benefit accrual.
2. The vesting rules.
3. The penalty imposed on a key employee receiving a distribution prior to age 59½ (other than because of death or disability), or who does not receive a distribution until after 70 1/2.
4. The effective date.
5. The five year look-back provision.

These items will be analyzed in detail in the remainder of our testimony.

A. DEFINED BENEFIT MINIMUM

Sections 416(c)(1)(A) and (B) of the Internal Revenue Code of 1954, as amended, ("Code") basically state that if a defined benefit plan is top-heavy, the plan must provide a minimum accrued benefit derived from employer contributions of not less than 2% of the participant's average compensation (averaged over a period of 5 years) multiplied by his years of service, with a maximum of 10 years. We feel, for the following reasons, that the benefit should be expressed in terms of a projected benefit at normal retirement rather than in terms of a current accrued benefit.

1). The additional expense of providing the 2% accrual of benefits per year of service over a ten-year period required in a top-heavy defined benefit plan, coupled with the application of the accelerated vesting requirements under TEFRA, would cause an extreme financial hardship to many plan sponsors.

2). Since a 2% accrual of benefits per year of service over a ten-year period is, under most circumstances, an extremely accelerated accrual, basically none of the actuarial cost (funding) methods presently acceptable to the Internal Revenue Service will generate enough monies prior to a participant's retirement date to provide these benefits. As you can see from the attached illustrations (Exhibit A), the plan is placed in an adverse financial position for most of the years in which the individual would be a participant, regardless of his age. We have illustrated only a $200 per month benefit for a $1,000 per month employee. If you consider that the benefit amount may be doubled, tripled, or even quadrupled (based on the compensation levels of the "non-key" employees), you can imagine the effects that this might have on a pension plan with a substantial number of participants. What would happen if the plan would terminate? Obviously a substantial underfunding has occurred and possibly, because of the employer's attempt to provide his employees with a pension plan, his corporation would be suddenly placed in a financial dilemma. What incentives would there be to establish a pension plan if an employer knew that the pension plan potentially could be a major factor contributing to his business' failure? Also, would a company ever consider acquiring another company if it had to assume the potential liability of that company's pension plan?

3). Under the current top-heavy rules an individual could go to work for a company at age 25, quit at age 35, go to work for a second company, quit that company at age 45, go to work for a third company, quit that company at age 55, and then finally go to work for a fourth company until age 65. Assuming that each company has a top-heavy defined benefit plan, he will receive 20% of his compensation as a retirement benefit from each company. Consequently, at age 65 he will be eligible for pension benefits of 80% of his averaged compensation. This is a rather large benefit to be classified as a "minimum". Hopefully, Congress did not intend this result. Thus, we feel that it would be more reasonable that the minimum benefit should be a projected benefit at normal retirement. At any particular time prior to attaining his retirement age, a participant's benefit earned to date would be at least equal to the result obtained by applying one of the acceptable accrual of benefit methods as outlined in Code Section 411(b) to the minimum projected benefit of the participant.

4). If accelerated plan costs cause a substantial number of plan terminations, an additional burden will be placed upon the Social Security system to provide more meaningful retirement benefits. Because of recent high unemployment and inflation, most wage earners are either unable or afraid to set money aside for retirement. We simply cannot afford to overburden the Social Security system with this additional problem.

B. VESTING

Code Section 416(b)(1)B states that if a plan is deemed top-heavy, an accelerated vesting schedule is mandated. It is our feeling that a 4-40 vesting schedule should be the most stringent schedule required in any type of plan (unless it can be shown that a pattern of abuse has occurred) for the following reasons:

1). Under the new graded vesting schedules of TEFRA, all participants must be 100% vested after six years of service with the employer. This seems contrary to the philosophy that retirement plans should be viewed as long-term commitments by both the employer and the employees. An accelerated vesting schedule can create an incentive for an employee to terminate employment in order to receive his benefits. Although an employer may withhold payments of a participant's vested benefits up to the time the participant becomes eligible for retirement, it is not practical to do so. Both the plan administrator and the Social Security system must be relied upon to keep track of this employee and provide him with periodic reports for years or even decades. This is both expensive and burdensome for all concerned.

Under the 4-40 vesting schedule, employees must complete eleven years of service with the employer to be 100% vested. This does not appear to be an unreasonable period of time as a commitment by the employee since an immense amount of time, effort and money is expended by the employer in making that employee productive. The retirement plan, therefore, should never be the incentive for an employee to leave, but rather it should be one of the incentives for him to stay.

2). In P.L. 97-12 President Reagan denied the Internal Revenue Service ("IRS") use of funds to enforce more stringent vesting schedules than the 4-40 vesting schedule in any type of plan, regardless of size. In Joint Resolutions H.J. Res. 325 and H.J. Res. 644, Congress likewise denied the IRS use of such funds. Evidently, both the President and Congress believed this was an acceptable and realistic schedule and indicated their endorsement of the concept that a retirement plan should be for long-term employees.

3). Small business has been discriminated against for many years. An example of this discrimination is found in the vesting schedules of pension plans. Accelerated vesting schedules are required for pension plans of smaller companies but are not required for the pension plans maintained by larger companies (see Exhibit B).

C. DISTRIBUTIONS

Code Section 72(m)(5) states that a "key employee" in a top-heavy plan is precluded from receiving a distribution prior to age 59 1/2 (other than because of death or disability) without an assessment of a premature distribution penalty equaling 10% of the total distribution. Additionally, Code Section 401(a)(9) states that a "key employee" must begin to receive a distribution of his vested interest prior to his attaining age 70 1/2 to avoid an excise tax equalling 50% of the amount by which the minimum dollar amount required to be distributed during a year exceeds the amount actually distributed. It is unfair to apply these two provisions at this time for the following reasons:

1). The age 59 1/2 distribution requirement will create a hardship for employees of established pension plans with specified retirement ages less than 59 1/2 where the employees had the full intention of retiring at that age. Many individuals retire at ages younger than that of the typical American citizen. The IRS in Revenue Ruling 78-331 ruled that if a plan is funding benefits to an age younger than age 65, it would have to be demonstrated that this age is a reasonable actuarial assumption and not merely a device to accelerate funding. The individuals who are expected to retire at an age prior to 65 must retire at that age or the employer would risk retroactive disallowance of past tax deductions attributable to the pension plan contributions. Thus, in abusive situations, the IRS has the authority to recalculate contributions, deductions and assess appropriate penalties. Again, it is our experience that most individuals who are funding toward an age younger that 65 fully expect to retire upon attaining that age. In any event, we do not feel it is fair to retroactively impose the 59 1/2 age distribution language at this time. If the principals of the business must now raise their retirement age, they will likewise raise the retirement age for the rank-and-file employees. Thus, all the pre-planning that employees have made for retirement will have to be changed.

2). Congress should recognize the fact that many individuals become successful in the later years of their life. It is unfair to penalize this group of people for attempting to save something for their retirement. In the last decade we have experienced record inflation, liberalization of credit, and a general feeling that Social Security would basically provide the primary source of income at retirement. Saving adequate amounts of money for retirement has not only been neglected, but in some cases, it has been virtually impossible. Older individuals should be encouraged, and not discouraged, to save. The Social Security system is already overburdened. The longer that payments can be postponed from the system, the greater its chance for survival. Thus, regardless of the employee's classification, (i.e. "key employee") we feel an equitable alternative to the new 70 1/2 provision would be to require distributions to commence on the later of age 70 1/2 or the plan's normal retirement date. This would cure any abuse which occurred prior to TEFRA where individual participants would attain their normal retirement age, continue working and opt for an indefinite late retirement.

D. MISCELLANEOUS TOP HEAVY

1). Code Section 416(g)(3) states basically that if an employee receives a distribution from a plan within the five year period ending on the date of the determination that the plan was top-heavy, that distribution would be added to the present value of the cumulative accrued benefits or account balances, depending on the type of plan. We feel this provision, if applied retroactively as of January 1, 1984, would be an administrative nightmare. Records regarding distributions of this nature in administrative take-over situations, mergers, etc. would be virtually impossible to obtain, and the taxpayer would face substantial administrative expenses in the attempt. We feel this sort of provision should be "phased-in" prospectively from January 1, 1984, the effective date of the top-heavy provisions, and should include only those distributions made upon termination of employment or retirement. Distributions upon death or disability should be disregarded.

2). Since a significant number of the provisions of Code Section 416 (top heavy) are complex and subject to numerous interpretations, we would recommend that the implementation of any of the provisions of this Code Section be delayed for at least two years. We are confident that a close analysis of this Code Section will reveal unrealistic and unworkable provisions and, through hasty implementation, will result in mass plan terminations.

E. PLAN LOANS

Plan loans should be made available for non-corporate employees on the same basis as for corporate employees. If there is to be parity of contributions and benefits between corporate and non-corporate business entities beginning in 1984, the ancilliary provisions of the plans in which these individuals participate should also have parity.

EXHIBIT A

EXHIBITS

PROJECTED BENEFIT ACCRUAL AND VESTING UNDER "TOP HEAVY" PLANS

(Monthly Retirement Benefit: $200 Annual Compensation: $12,000)

(25 Year Old Male Participant Retiring at Age 65)

AGE	Annual Contribution To Plan	Estimated Accumulation of Plan Contributions	Monthly Accrued Benefit	Present Value of Accrued Benefit	Vested Percentage of Accrued Benefit	Vested Present Value of Accrued Benefit	Plan Recapture In Event of Participant Termination
25	$ 0	$ 0	$ 0	$ 0	0%	$ 0	$ 0
26	198	198	20	356	0	0	198
27	198	405	40	747	20	149	256
28	198	623	60	1,177	40	471	152
29	198	852	80	1,648	60	989	(137)
30	198	1,092	100	2,163	80	1,730	(638)
31	198	1,344	120	2,726	100	2,726	(1,382)
32	198	1,609	140	3,339	100	3,339	(1,730)
33	198	1,887	160	4,007	100	4,007	(2,120)
34	198	2,178	180	4,733	100	4,733	(2,555)
35	198	2,485	200	5,522	100	5,522	(3,037)
36	198	2,807	200	5,798	100	5,798	(2,991)
37	198	3,145	200	6,088	100	6,088	(2,943)
38	198	3,499	200	6,392	100	6,392	(2,893)
39	198	3,872	200	6,712	100	6,712	(2,840)
40	198	4,263	200	7,048	100	7,048	(2,785)
41	198	4,674	200	7,400	100	7,400	(2,726)
42	198	5,105	200	7,770	100	7,770	(2,665)
43	198	5,558	200	8,158	100	8,158	(2,600)
44	198	6,033	200	8,566	100	8,566	(2,533)
45	198	6,533	200	8,995	100	8,995	(2,462)
46	198	7,057	200	9,444	100	9,444	(2,387)
47	198	7,607	200	9,917	100	9,917	(2,310)
48	198	8,185	200	10,412	100	10,412	(2,227)
49	198	8,792	200	10,933	100	10,933	(2,141)
50	198	9,429	200	11,480	100	11,480	(2,051)

EXHIBIT A

PROJECTED BENEFIT ACCRUAL AND VESTING UNDER "TOP HEAVY" PLANS

(Monthly Retirement Benefit: $200 Annual Compensation: $12,000)

(25 Year Old Male Participant Retiring at Age 65)

AGE	Annual Contribution To Plan	Estimated Accumulation of Plan Contributions	Monthly Accrued Benefit	Present Value of Accrued Benefit	Vested Percentage of Accrued Benefit	Vested Present Value of Accrued Benefit	Plan Recapture In Event of Participant Termination
51	$ 198	$ 10,098	$ 200	$ 12,054	100%	$ 12,054	$(1,956)
52	198	10,801	200	12,656	100	12,656	(1,855)
53	198	11,538	200	13,289	100	13,289	(1,751)
54	198	12,313	200	13,954	100	13,954	(1,641)
55	198	13,126	200	14,651	100	14,651	(1,525)
56	198	13,980	200	15,384	100	15,384	(1,404)
57	198	14,876	200	16,153	100	16,153	(1,277)
58	198	15,818	200	16,961	100	16,961	(1,143)
59	198	16,806	200	17,809	100	17,809	(1,003)
60	198	17,844	200	18,699	100	18,699	(855)
61	198	18,934	200	19,634	100	19,634	(700)
62	198	20,078	200	20,616	100	20,616	(538)
63	198	21,279	200	21,647	100	21,647	(368)
64	198	22,541	200	22,729	100	22,729	(188)
65	198	23,866	200	23,866	100	23,866	0

EXHIBIT A

ACCRUAL OF BENEFITS UNDER
THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

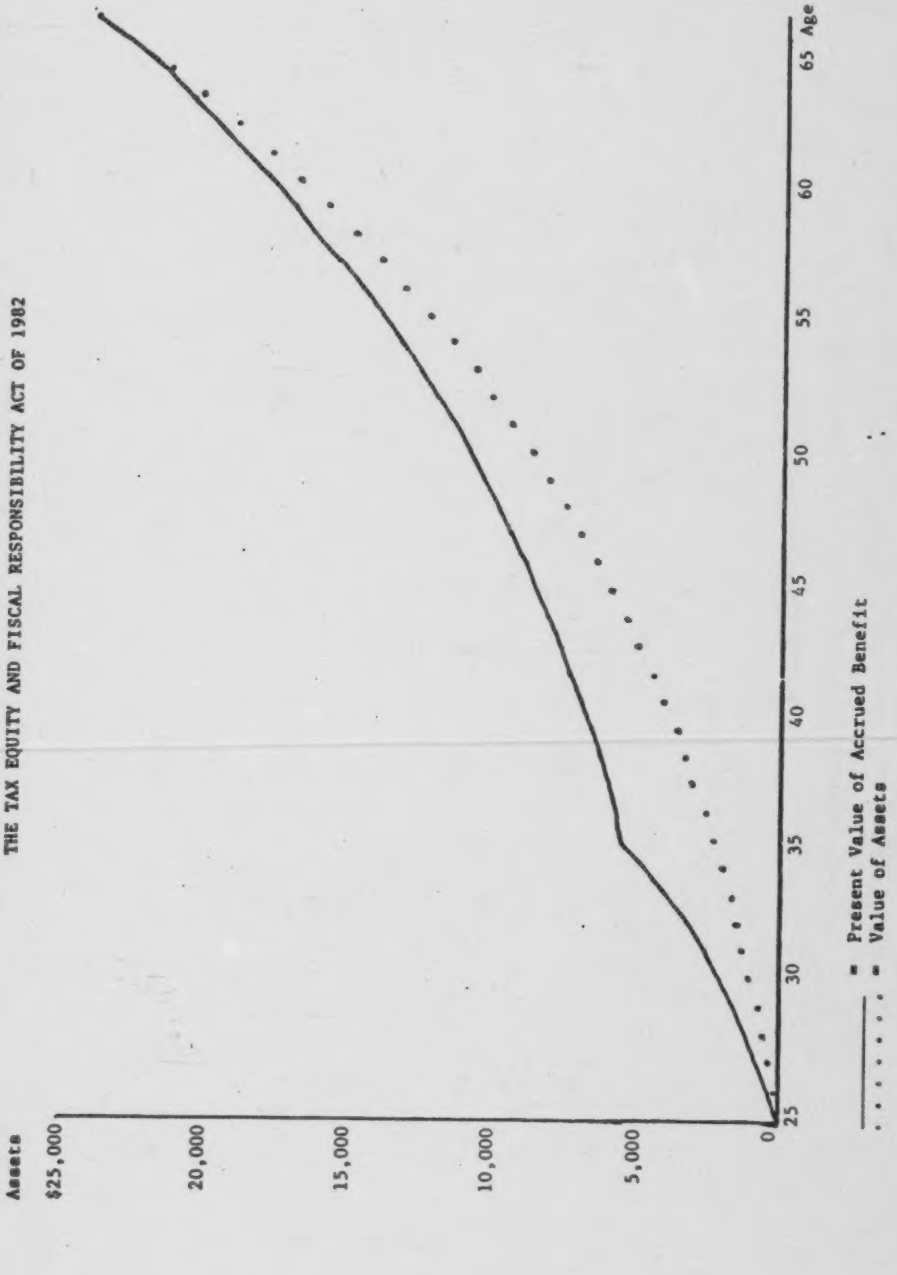

EXHIBIT A

PROJECTED BENEFIT ACCRUAL AND VESTING UNDER "TOP HEAVY" PLANS

(Monthly Retirement Benefit: $200 Annual Compensation: $12,000)

(50 Year Old Male Participant Retiring at Age 65)

AGE	Annual Contribution To Plan	Estimated Accumulation of Plan Contributions	Monthly Accrued Benefit	Present Value of Accrued Benefit	Vested Percentage of Accrued Benefit	Vested Present Value of Accrued Benefit	Plan Recapture In Event of Participant Termination
50	$ 0	$ 0	$ 0	$ 0	0%	$ 0	$ 0
51	1,106	1,106	20	1,205	0	0	1,106
52	1,106	2,267	40	2,531	20	506	1,761
53	1,106	3,487	60	3,987	40	1,595	1,892
54	1,106	4,767	80	5,381	60	3,349	1,418
55	1,106	6,111	100	7,326	80	5,861	250
56	1,106	7,523	120	9,230	100	9,230	(1,707)
57	1,106	9,005	140	11,307	100	11,307	(2,302)
58	1,106	10,561	160	13,569	100	13,569	(3,008)
59	1,106	12,195	180	16,028	100	16,028	(3,833)
60	1,106	13,911	200	18,699	100	18,699	(4,788)
61	1,106	15,713	200	19,634	100	19,634	(3,921)
62	1,106	17,604	200	20,616	100	20,616	(3,012)
63	1,106	19,590	200	21,647	100	21,647	(2,057)
64	1,106	21,676	200	22,729	100	22,729	(1,053)
65	1,106	23,866	200	23,866	100	23,866	0

ACCRUAL OF BENEFITS UNDER
THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

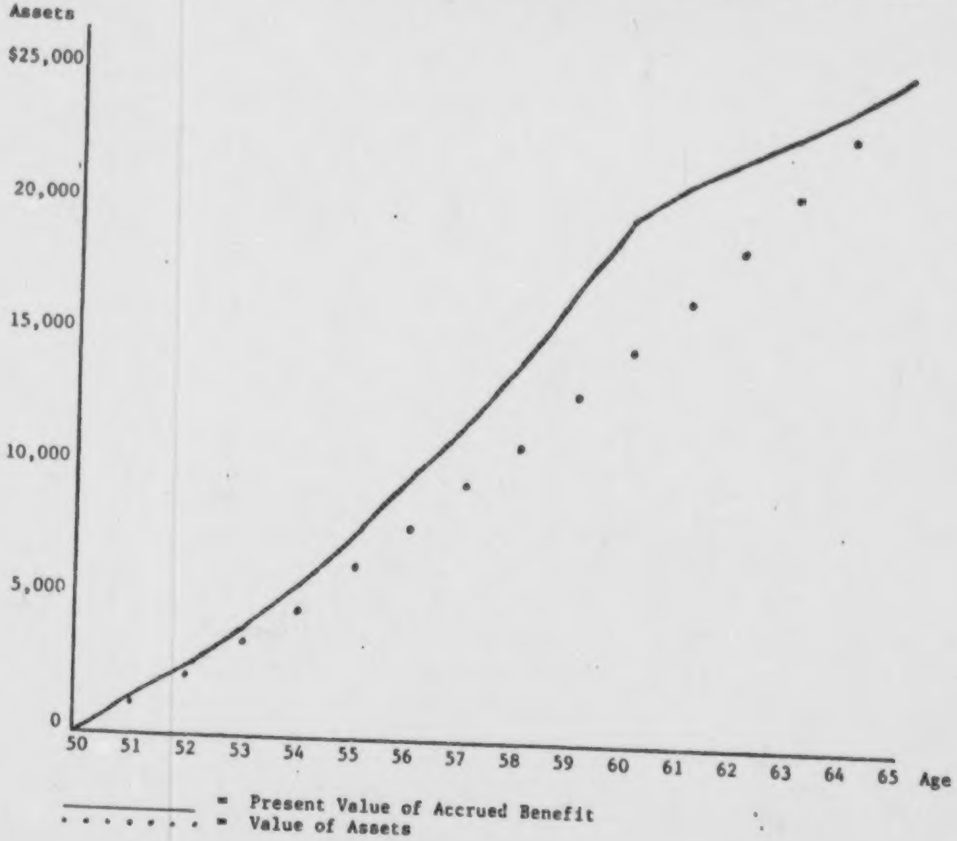

EXHIBIT A

A). ACTUARIAL ASSUMPTIONS

1). PRE RETIREMENT

a).	INTEREST:	5%
b).	MORTALITY:	NONE
c).	SALARY PROGRESSION:	NONE
d).	TURNOVER:	NONE
e).	DISABLEMENT:	NONE
f).	EXPENSES:	NONE
f).	LOADING FOR SUBSIDIZED BENEFITS:	NONE

2). POST RETIREMENT

a).	INTEREST:	5%
b).	MORTALITY:	1971 GROUP ANNUITY MORTALITY TABLE
c).	EXPENSES:	NONE

B.) ACTUARIAL METHOD

The actuarial cost method illustrated is the Individual Level Premium Cost Method as described under Part II - Clause (ii)(B) of the Internal Revenue Service Bulletin on Section 23 (p)(1)(A) and (B) of the 1939 Internal Revenue Code. This method is also one of the acceptable actuarial cost methods under the Employee Retirement Income Security Act of 1974.

NOTE: It is assumed that all actuarial assumptions are exactly realized.

EXHIBIT B

VESTING SCHEDULES
FOR 10 LARGE OIL RELATED COMPANIES

NAME OF COMPANY	APPROXIMATE NUMBER OF PLAN PARTICIPANTS	DESCRIPTION OF VESTING SCHEDULE
ASHLAND OIL	7,000	100% after 10 years of service; 0% prior to 10 years.
ATLANTIC RICHFIELD	21,000	100% after 10 years; 0% prior to 10 years.
DOW CHEMICAL	Not Available	50% after 5 years, 10% per year thereafter; 0% prior to 5 years.
EXXON CORPORATION	30,000	100% after 10 years; 0% prior to 10 years.
GULF OIL CORPORATION	28,000	10 years of service, or age 50 and over plus service totals to 60 or more - 100%; 0% prior.
MOBIL OIL CORPORATION	33,000	100% after 10 years; 0% prior to 10 years.
STANDARD OIL COMPANY	33,000	100% after 10 years; 0% prior to 10 years.
SUN OIL COMPANY	16,000	100% after 10 years; 0% prior to 10 years.
TENNECO	24,000	100% after 10 years; 0% prior to 10 years.
TEXACO	30,000	100% after 10 years; 0% prior to 10 years.

Senator CHAFEE. Mr. Holleman.

STATEMENT OF VERNON HOLLEMAN, JR., CHAIRMAN, PENSION COMMITTEE, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING, WASHINGTON, D.C.

Mr. HOLLEMAN. Mr. Chairman, my name is Vernon Holleman. I am chairman of the Pension Committee of the Association for Advanced Life Underwriting. I'm accompanied by Stewart Lewis, counsel to AALU.

I appreciate the opportunity to testify on the effect of changes made by the Tax Equity and Fiscal Responsibility Act of 1982 on the private pension system. Because much of the work of AALU members involves the design, establishment, and administration of qualified retirement plans, and other employee benefits, we are particularly interested in the topic of today's hearing.

While we feel that many of the more restrictive aspects of TEFRA impact unfairly on small business and will be detrimental to the expansion of the private pension system in providing retirement security for employees, we do not expect this subcommittee to move to reverse major policy decisions made in the enactment of TEFRA. Therefore, I will restrict my comments to more constructive suggestions that while modifying the statutory provisions of TEFRA are not inconsistent with the general policy directions contained in TEFRA.

Because of the limited time available, I will not attempt in my oral presentation to review in detail the numerous specific changes in TEFRA that AALU feels are appropriate. A discussion of these changes is contained in my formal statement, which the members of the subcommittee may consider in greater detail at a later time.

I would, however, like to take the time to stress three major legislative goals that we recommend to the subcommittee, as well as to the full Senate Finance Committee. First, and of major substantive importance, is the need to achieve full parity in employee benefits between corporate and noncorporate employers. TEFRA made substantial progress in this regard by largely eliminating one of the major distinctions that existed between corporate and noncorporate employers. That is, it largely eliminated the distinction between corporate and noncorporate qualified retirement plans.

Other distinctions, however, have been continued, such as rules for providing group term life insurance and health benefits to employees. While some justification may have existed years ago for developing the distinction between corporate and noncorporate employers, the proliferation of professional corporations has made it abundantly clear that this distinction no longer serves any valid policy purpose. We, therefore, urge that Congress promptly move to eliminate all further distinctions between corporate and noncorporate employers for purposes of the taxation of employee benefits.

Second, employers, especially small employers, are faced with an enormous task over the next few months. Not only must employers modify their plans to bring them into compliance with the statutory changes enacted by TEFRA, they must also make necessary modifications to comply with new regulations continually being issued by the Internal Revenue Service, new interpretations of these regulations, and other statutory changes included, and previously enacted pension legislation.

These changes must be made notwithstanding the fact that the Internal Revenue Service currently has an enormous backlog of regulation projects, and has not even issued adequate guidance under previous tax laws much less under TEFRA.

This burden is especially severe for small plans, since the impact of TEFRA falls mostly on small employers, and since small employers can least afford the administrative cost of frequent plan amendments and Internal Revenue Service approvals. Therefore, it is vital that Congress move promptly to postpone at least 1 year the general effective date of those TEFRA rules requiring plan changes.

Third, we are concerned about the way in which Congress enacted TEFRA without adequate opportunity for public input. Certainly, whenever major legislation, whether it be pension legislation or not, is enacted, the public should have the opportunity to make their views known to Congress. This was not the case during the enactment of TEFRA, which essentially emanated from a conference between the Senate Finance Committee and the House Ways and Means Committee, even though the House had not even enacted legislation on the subject. Legislating in this fashion will only lead to serious mistakes through eliminating the opportunity for full consideration of proposed legislative changes.

We commend this subcommittee for taking the time and effort to provide hearings to consider the impact of TEFRA; therefore, providing an opportunity for the public to comment. We urge that the subcommittee work to insure that this process is continued when specific legislation is being considered.

Senator CHAFEE. Thank you, Mr. Holleman.

[The prepared statement of Mr. Holleman follows:]

STATEMENT OF VERNON W. HOLLEMAN, JR., CLU, CHAIRMAN OF THE PENSION COMMITTEE, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

Presented on Behalf of the
Association for Advanced Life Underwriting
and the National Association of Life Underwriters
Before the Subcommittee on Savings,
Pension and Investment Policy of the
United States Senate Committee on Finance

April 11, 1983

My name is Vernon Holleman. I am accompanied by Gerald H. Sherman and Stuart M. Lewis of the Washington, D.C. law firm of Silverstein and Mullens, who are counsel to the Association for Advanced Life Underwriting (AALU).

AALU is a nationwide organization of approximately 1,100 members specializing in one or more fields of advanced life underwriting. Collectively our members are responsible for annual sales of life insurance in excess of $2 billion, mostly in circumstances involving complex factual situations and often dealing with qualified retirement plans and other employee compensation techniques. Much of the work performed by our members is with small businesses. Consequently, AALU is in a position to speak with authority concerning the problems of the small business community with respect to the private pension system.

AALU is a division of the National Association of Life Underwriters (NALU). NALU, which has a membership of 1,022 state and local associations with a combined individual membership of over 120,000 life insurance agents, general agents and managers, joins AALU in the submission of these comments.

We appreciate the opportunity to testify on the effect of changes made by the Tax Equity and

Fiscal Responsibility Act of 1982 (TEFRA) on the private pension system. Fortunately, many of the changes included in TEFRA were delayed until 1984, providing an opportunity for further consideration of these changes and their impact on employees and the business community. We commend the Subcommittee for holding hearings to address the impact of these changes and giving consideration to the need for possible legislative adjustments before these changes become fully effective.

While the pension provisions of TEFRA included some changes that will be beneficial to both employers and employees, many of its provisions will have the effect of restricting the availability of pension and profit sharing plans and otherwise limiting the flexibility and operation of such plans. In general, AALU believes that many of the more restrictive aspects of TEFRA impact unfairly on small business and will be detrimental to the expansion of the private pension system in providing retirement security for employees. In the belief, however, that the Subcommittee does not wish to hear testimony asking for a reversal of major legislation enacted in the last session of Congress, however, we will not dwell on changes that would involve an outright reversal of the policies enacted by TEFRA. Instead, we will emphasize modifications in TEFRA that we believe would be consistent with the apparent policy goals in TEFRA while minimizing some of the adverse consequences that would otherwise result.

Before addressing these more specific modifications in the TEFRA rules that we believe should be the subject of legislation in this session of Congress, let me outline three broad policy concerns raised by TEFRA.

General Policy Concerns Raised by TEFRA

1. The Need for Full Parity Between Corporate and Non-corporate Employers

One of the major beneficial aspects of TEFRA was the move to partial parity between corporate and non-corporate employers. Particularly, in the treatment of qualified retirement plans, TEFRA largely eliminated an anacronistic distinction that existed in the law between corporate and non-corporate employers. As the proliferation of professional corporations in recent years has made clear, the distinction is almost entirely one of form rather than one of substance and its perpetuation in the income tax laws does not serve to further any valid purpose. Instead, this distinction merely adds unnecessary complication to the laws and encourages the incorporation of many businesses that would otherwise have continued to operate in non-corporate form. In short, the net result has been a proliferation of corporate entities motivated by the desire to utilize tax benefits available only to corporations when there is, in fact, no valid policy reason why the tax benefits should have been so limited.

Because TEFRA has taken the tax laws most of the way to full parity, it is appropriate for Congress to now enact legislation completing the process. Even after TEFRA, business entities must still resolve the question whether it is more advantageous to operate in corporate or non-corporate form -- purely for tax reasons. There is no policy justification for this distinction, as TEFRA recognized, and consequently, Congress should eliminate the other distinctions that exist in the law between corporate and non-corporate fringe benefits. Two of the most important of these are the treatment of group-term life insurance and the treatment of medical benefits for employees. Under the statutory rules of sections 79 and 105, respectively, these benefits are only available through corporate form even though on policy grounds self-employed individuals, as well as corporate employees, are equally entitled to the benefit of these rules.

We therefore recommend that Congress promptly enact legislation eliminating all further distinctions in the tax laws in the employee benefit area between corporate and non-corporate business entities so that any benefits that are available for corporate employees should be equally available for self-employed individuals. While we recognize that there may be a significant revenue cost in the enactment of such a proposal, we believe the arbitrariness of the existing rules and their total lack of justification on policy grounds makes it important for Congress to take this action regardless of the revenue effects.

2. Need for Effective Date Delays in TEFRA

Most of the pension provisions enacted as part of TEFRA provide for substantial restrictions and limitations on the use of employee benefits for employees. These restrictions principally impact smaller businesses, leaving large corporations with only minimal modifications in accommodating TEFRA.

Major pension legislation has, in recent years, unfortunately, become too frequent, including, for example, the Economic Recovery Tax Act of 1981, the Multiemployer Pension Plan Amendments Act of 1980, the Revenue Act of 1978, and the Tax Reform Act of 1976. Following each of these legislative enactments the Internal Revenue Service develops, over an extended period of time, proposed and final regulations that contain additional changes not clearly envisioned as part of the statutory changes. Further, the Internal Revenue Service, in its administration of these laws, changes its interpretations through revenue rulings and other announcements that require further plan changes.

Plans are expected to be continually updated and submitted to the Internal Revenue Service for approval of their qualified status under the tax laws. This has become a difficult burden for employers and plan administrators. Yearly keeping up to date with regulatory changes would be a substantial burden but the added impact of the frequent legislative changes, especially the major changes included in TEFRA, have substantially exacerbated this problem. Coupled with this is the fact that most of the adverse changes made by TEFRA impacted primarily on small businesses, a group less capable of accommodating these frequent changes than other segments of the business community.

The result is the creation of substantial administrative burdens and an increase in operating costs for pension and profit sharing plans, especially for small business. These cost increases result not only from the substantive impact of the changes in the rules, but also from the mere administrative necessity of keeping the plans up to date with the applicable legal requirements. Especially in the case of small plans, this burden may be very substantial indeed.

Although TEFRA provided a delayed effective date (until 1984) for many of these plan changes, we believe that these changes, when coupled with the other changes that plans must accommodate, make an even longer delay in the effective date advisable. We urge that Congress immediately defer the effective date of all the TEFRA changes that require changes in qualified pension and profit sharing plans until at least 1985.

This added time would, in addition to permitting plans and employers a more orderly period of time in which to accommodate these changes, give the Internal Revenue Service an opportunity to develop the details of the rules and regulations that are necessitated by the statutory changes of TEFRA and the earlier tax laws. Given the heavy backlog of the regulations projects at the Internal Revenue Service, unless this further delay is granted, it is unlikely that the Internal Revenue Service will have issued all of the guidance necessary for plans to properly comply with these new laws by this fall, which is essentially when plans must be brought into compliance with these new laws. We therefore urge that a delay of at least one year be made in the effective date of the pension provisions of TEFRA that require amendments to qualified plans.

3. Congress Should Better Open the Legislative Process to the Public in Developing Major Changes in the Law

One of the most unfortunate aspects of TEFRA was the process by which it was enacted. As members of this Subcommittee will recall, the legislation was initiated by the Senate Finance Committee with no real opportunity for public comment on the pension provisions. While the House Ways and Means Committee held a one-day hearing on a pension bill introduced by Congressman Rangel, no hearing on the pension provisions of the bill that became TEFRA was ever held. The bill went directly to conference (even though the House had not passed legislation) where major changes, well beyond the scope of the provisions enacted by the Senate, were made. In fact, the pension provisions of TEFRA as enacted by the Senate were limited to cutbacks in the contribution and benefit limitations under section 415 of the Code and loan restrictions. What emerged from conference -- without any chance for the public to comment and without adequate opportunity for the public to become notified of the changes -- was a vastly different bill with major restrictions on the use of pension plans.

The legislative process is designed to give the public a chance to have its views known. TEFRA essentially denied the public this opportunity and we urge the Subcommittee to ensure that this type of closed legislation process does not again occur. We sincerely hope that an effort will be made by the Subcommittee and by the Finance Committee generally to open the legislative process to public comments and bi-partisan participation.

Specific Comments Relating to the Pension Provisions of TEFRA

In an attempt to offer constructive suggestions regarding the pension provisions of TEFRA, we would like to submit some specific suggestions for modifications in TEFRA. We have not asked for repeal of major TEFRA provisions since we assume Congress would not be willing to consider such policy changes at the present time. Our specific comments are summarized briefly below.

1. Simplification of the Estate Tax Exclusion for Pension Benefits

TEFRA imposed for the first time a dollar limitation on the estate tax exclusion available for distributions from qualified retirement plans and IRAs. Section 2039(g) of the Code imposes a $100,000 cumulative limit on this exclusion. Unfortunately, in enacting section 2039(g), no attempt was made to simplify the complex rules that previously existed in section 2039(c). Those complex rules may have been justified at the time when the estate tax exclusion of section 2039(c) was unlimited but in view of the relatively low limits imposed under current law, major simplification of the rules of section 2039(c) is appropriate.

One of the major complications involved in the exclusion available under section 2039(c) is the requirement that the beneficiary must waive 10 year forward averaging treatment under section 402(e) in order to obtain the benefits of the estate tax exclusion of section 2039(c). The purpose of this requirement was that the potentially substantial benefits of the estate tax exclusion and the income tax advantages of 10 year forward averaging should not both be available for a given distribution. Since, however, the benefit of the estate tax exclusion has been severely limited, a substantial simplification of the law could be made by eliminating the requirement that 10 year forward averaging be waived as a condition of the estate tax exclusion of section 2039(c). This would avoid what in practice is a complex problem of determining whether a beneficiary should utilize the advantages of 10 year forward averaging or take the estate tax exclusion. This problem may be particularly severe if the pension beneficiary has no economic interest in the estate tax burden on the decedent's estate. For example, the beneficiary of a qualified plan distribution may not have any interest in the amount of estate taxes paid by the estate. As a consequence, the estate tax exclusion may be of no interest to the beneficiary, who may then elect 10 year forward averaging, passing the burden of the added estate taxes onto other parties.

In addition, section 2039(c) prohibits the use of the estate tax exclusion if the qualified plan benefits are payable directly or indirectly to the estate. Especially in the case of distributions to trusts, this has lead to unnecessary complications in the drafting of trust instruments. Under the Internal Revenue Service's interpretation, if the trust is required to assist in the payment of estate taxes then the estate tax exclusion is lost whereas if it is merely permissible that the trust participate in the payment of estate taxes, the exclusion is retained. Especially after the enactment of section 2039(g), no policy reason is apparent for retaining the rule that the payments not be made to the estate of the decedent. Payments made to the estate of the decedent are eventually passed through to the same beneficiaries that the decedent probably intended to receive the money. As a consequence, the distinctions in section 2039(c) serve no valid policy interest while adding substantial complication to the law.

AALU therefore recommends that the rules regarding 10 year forward averaging and payments to an estate under section 2039(c) be eliminated, especially in view of the limitations imposed on the estate tax exclusion by section 2039(g).

2. Expansion of the Estate Tax Exclusion for Pension Benefits

AALU further recommends that the limit on the estate tax exclusion under section 2039(g) be expanded at least to $500,000 from the present $100,000 limit. $500,000 was the limitation originally proposed by Congressman Rangel in his legislation and nowhere in the legislative consideration of TEFRA was any contrary public suggestion made until the final legislation was produced by the Conference Committee. In short, the $100,000 limit was arrived at with no opportunity for public consideration.

The essential purpose of the federal estate tax was initially, and continues to be, the breakup (at death) of substantial accumulations of wealth by individuals. Revenue has never been a major justification for the federal estate tax and should only be considered an incidental benefit of the federal estate tax. The basic policy reason for the federal estate tax, i.e., breaking up substantial accumulations of wealth, really has no application to accumulations of pension benefits in retirement plans. These amounts represent retirement income earned during working years and are inherently different from substantial passive accumulations of wealth that individuals may develop. As such, there is an important policy reason for distinguishing between the estate tax treatment of retirement income accumulated in a qualified retirement plan and other capital owned by a decedent.

AALU urges that the estate tax exclusion under section 2039(g) be raised at least to $500,000.

3. Denial of Survivor Annuities to Dependents

A technical provision enacted as part of TEFRA attempted to codify existing Internal Revenue Service interpretations regarding the payments of benefits from a retirement plan after the death of an employee. Under section 401(a)(9)(B) of the Code, generally an employee's entire interest in a qualified plan must be distributed within five years after his death or the death of his surviving spouse. An exception is made for payments to a surviving spouse so that the spouse may receive the balance of the decedent's interest in a lifetime annuity. Unfortuntely, no further exceptions were made in the statutory provisions so that under the statute it is no longer permissible for a child to receive an annuity over life.

AALU recommends that this statutory provision be changed to eliminate the five year requirement on the payment of proceeds upon a decedent's death. Providing for dependents through annuities serves an important social goal in many situations. A parent may, for example, recognize that due to some mental or physical handicap, a child may be unable to provide for himself during his lifetime and therefore may wish to establish a lifetime annuity for that child to help provide income security throughout the child's life. As a result of section 401(a)(9)(B), this type of annuity would no longer be possible. Since section 401(a)(9)(B) was explained as merely a codification of existing rules when in fact it represented a major change in the existing rules in this respect, we believe it would be appropriate for Congress to promptly modify these statutory provisions to return to the rules as they existed before the enactment of TEFRA, which permitted lifetime annuities to be provided to beneficiaries following the death of the decedent.

4. Loan Limitations

TEFRA enacted substantial restrictions on the ability of qualified plans to make loans to employees. As enacted, those provisions generally require loans to be repaid within five years and only permit employees to borrow one-half of their vested interest in the plan up to a maximum of $50,000. While we question the advisability of imposing any such specific limitations on the ability of plans to make loans to employees, we believe it is particularly unfair to impose an arbitrary dollar limitation on the maximum amount of a loan. This limitation adversely impacts those with larger plan interests and is not justified by any policy consideration. All loans must be bona fide (not disguised distributions) and must be repaid within five years. An individual who has a more substantial vested interest in a plan should at the very least have the same rights to plan loans as an individual who has a smaller interest in the plan. If the general loan limitation is that an employee cannot borrow more than one-half of his vested interest from the plan then that should be the loan restriction for all employees without regard to a dollar limit.

AALU therefore recommends that the $50,000 cap on loans to plan participants be eliminated in favor of a rule limiting the amount of loans to one-half of the employee's vested interest.

5. Pension Withholding

One of the more controversial changes enacted by TEFRA was the change in presumption for purposes of the withholding requirements for distributions from pension and profit sharing plans.

Under the laws that existed before the enactment of TEFRA, employees had the right to elect to have pension withholding if they so chose. Employees who did not wish to have withholding could, by taking no action, avoid withholding.

TEFRA changed this presumption while keeping the withholding system for pension distributions voluntary. Employees must now elect out of withholding but are free to do so at will. This is totally unlike the situation regarding withholding on interest and dividends where withholding is in essence, mandatory. For pension plans, withholding is entirely voluntary and employees can merely elect out.

The net effect of these withholding rules is simply to add substantial paperwork for plan administrators who must now comply with the various notification requirements and election procedures promulgated by the IRS following the enactment of section 3405 of the Code. Our experience has already shown that the change in presumption as a result of this voluntary withholding system has not accomplished anything other than a substantial increase in the paperwork burden imposed on plan administrators and other payors of pension benefits. Employees who do not wish to have withholding -- the vast majority of all pension benefit recipients -- simply file the necessary elections and avoid the withholding requirements.

AALU recommends that the provisions of section 3405 be modified to again make withholding an elective procedure by the employee and, if necessary, to increase the reporting requirements for qualified plans in lieu of requiring the various elections and notifications included as a result of TEFRA. This will accomplish a substantial reduction in the paperwork burden with no substantive impact on revenue collection.

6. Top-heavy Rules -- Incorporation in all Plan Documents

Section 401(a)(10)(B), enacted by TEFRA, requires that plans incorporate all of the top-heavy rules of section 416 even if they are not in fact top-heavy. That statutory provision, however, authorizes regulatory exceptions to this requirement. Under proposed regulations recently issued by the Internal Revenue Service, essentially all plans, even those of the largest corporations, would be required to include the top-heavy rules in their plan documents.

The requirements of section 416 relating to top-heavy plans are extensive and the inclusion of these provisions in plans will require lengthy plan amendments. The Internal Revenue Service generally does not permit incorporation by reference and has indicated in the proposed regulations that it will also generally not permit incorporation by reference as it relates to the top-heavy requirements of section 416.

As interpreted, the net effect of this rule will be that essentially all qualified pension and profit sharing plans will be required to include the top-heavy provisions, even though there is little or no likelihood of the plans ever becoming top-heavy. This clearly represents excessive paperwork and administrative burdens being imposed on plans without justification. While it is hoped that the Internal Revenue Service will change its views, the statutory provision enacted by TEFRA may be read to suggest that Congress intended an all-inclusive rule rather than a rule in which only those plan that are actually top-heavy are required to include the top-heavy rules.

AALU recommends that the statute be modified to make it clear that only plans that are, in fact, top-heavy must incorporate the top-heavy rules. Otherwise, plans will be forced to add numerous provisions to their documents with the resulting confusion among participants, the unnecessary paperwork, the added administrative cost and the other problems.

7. Top-heavy Plans -- Class Year Vesting

Under the top-heavy rules of section 416, as added by TEFRA, plans that are top-heavy must utilize one of two rapid vesting schedules. One of these vesting schedules requires full vesting after three years of service and the other requires graded vesting from the second year of service through the sixth year of service at which time 100% vesting occurs. One of the problems created by this vesting schedule occurs when a plan is only in top-heavy status part of the time. Once a plan becomes top-heavy the vesting schedules of section 416(b) become applicable but unfortunately, if the plan loses its top-heavy status at a later time, it probably will be unable to revert to the old vesting schedule applicable to plans that are not top-heavy. (This results because of the requirements of section 411(a)(10) which in general prohibit a plan amendment decreasing the vesting of a participant). In essence the result will be that if a plan ever becomes top-heavy it will be locked into the top-heavy vesting schedule more or less permanently.

A more appropriate result would be to require faster vesting for plan years in which the plan is top-heavy but permit the plan to use a normal vesting schedule for years in which the plan is not top-heavy. For plans that continue to be top-heavy year after year, this will mean no major change in net result. The only plans affected by this modification would be those plans that move in and out of top-heavy status.

This result could be reached by permitting top-heavy plans a third choice in the vesting schedule -- class year vesting. Under a class year vesting schedule, contributions are grouped by the year of contribution and vest in accordance with a prescribed schedule independently as to each class year. A contribution made for the 1984 class year (when a plan was top-heavy) might fully vest, for example, in three years whereas a contribution made for the 1985 class year (when the plan was not top-heavy) would vest over a longer period of time (no more than five years is permitted under the current rules). This change would avoid the penalty that is imposed under the current rules for plans which, although generally not top-heavy, have become top-heavy in a given year. It should be noted that a plan may become top-heavy through no fault of the employer (if, for example, an employee quits) and consequently, top-heavy status can arise from actions unrelated to the employer.

8. Top-heavy Plans -- Slower Vesting Needed

As previously noted, under section 416(b) enacted by TEFRA, certain fast vesting schedules are required for top-heavy plans. In addition to the change outlined above permitting plans to use class year vesting, we feel that the vesting schedules for top-heavy plans are unnecessarily fast. Retirement plans should provide retirement savings and not current compensation. Employees are rewarded through salary payments for their current services with retirement plans providing benefits that reward employer loyalty and aid employees in their retirement security. The unnecessarily fast vesting schedules enacted by TEFRA have the effect of largely changing the essential purpose of retirement plans and making them in the nature of current, rather than deferred, compensation for retirement.

AALU recommends that the vesting requirement for top-heavy plans be modified so that slower vesting is permitted. A vesting schedule such as graded 10 year vesting would be far more appropriate than full vesting over three or six years. This is especially true for defined benefit plans which are even more oriented towards retirement savings than are profit sharing plans. Even if this change were made only for defined benefit plans, it would represent a very useful improvement in the law and one that would help to erase an imbalance that currently exists in favor of defined contribution plans over defined benefit plans.

9. Top-heavy Plans -- Testing for Top-heavy Status

Under the current rules of section 416, plans are determined to be top-heavy as of the last day of the preceding plan year. An exception is provided for the first year of plan operation during which the plan is tested for top-heavy status as of the last day of that initial plan year.

These testing rules create a potential unfairness for plans that move in and out of top-heavy status in that the top-heavy rules may be applicable in plan years in which the plan is not, in fact, top-heavy. It would be more appropriate to test the top-heavy status of the plan as of a day within that plan year rather than as of a day in a prior plan year. This could be done either through a mandatory change in the testing date for plan status or by permitting plans to make an election to have top-heavy status tested as of the last day of their plan year instead of the last day of the preceding plan year.

10. Top-Heavy Plans -- Accrual Rate

Under section 416(c) of the Code, top-heavy defined benefit plans are required to accrue a benefit up to 20% of the participant's average compensation. This minimum benefit is accrued at the rate of two percent per year for each year of service with the employer in which the plan is top-heavy.

As noted above in connection with vesting, and especially in the case of defined benefit plans, the essential policy justification for retirement plans is to provide retirement security for employees as a reward for their continued service with the employer. It is inappropriate to convert these plans to fast vesting, rapid benefit accrual plans that make them more a form of compensation for each year of service.

AALU believes that the rapidity with which top-heavy plans must accrue benefits is inappropriate and will encourage employees to change employment after having accrued the minimum benefit in 10 years. At the very least, a 20 year accrual period (with a one percent per year accrual rate) should be provided to discourage employees from terminating employment merely to accrue additional benefits from another employer and to instead provide an incentive for employees to continue employment with their employer.

11. Top-heavy Plans -- Distribution Requirements

In separate rules added by TEFRA, key employees in top-heavy plans are required to begin receiving distribution of their pension benefits, even if still employed, by age 70 1/2. Similarly, key employees are subject to penalties if they receive distribution before age 59 1/2 even if the person has terminated employment. These rules derive from the restrictions imposed on owner/employees in Keogh plans, which, in 1962, were justified in part by the inability to determine when an owner/employee terminated employment. These rules unnecessarily complicate the administration of pension and profit sharing plans without any policy justification. A key employee, as well as any other employee who continues in employment, should not be forced to receive distribution while still employed. As noted previously, the estate tax exclusion available to employees is largely eliminated so that no major estate tax benefits are available for deferral of distributions. Employees who legitimately continue in employment should not be forced to receive distribution while still employed, but should be permitted, like other employees, to defer distribution until retirement.

Likewise, employees who separate from service before reaching age 59 1/2 should not be penalized for receiving distribution at separation from service. Very strong administrative reasons exist why participants, even key employees, should receive distribution at the time of separation from service. To force plans to hold amounts due to terminated employees may substantially increase administrative burdens. It is unfair and inappropriate to impose penalty taxes on one employee who happens to be a key employee under the statutory definition and not to impose a penalty tax on another similarly situated employee when both terminate employment before age 59 1/2.

AALU finds no policy justification for these special distribution rules for key employees and recommends that they be eliminated.

Concluding Remarks

I appreciate very much the opportunity to present AALU's views to the Subcommittee and sincerely hope that the Subcommittee will give prompt consideration to the development of corrective legislation that will at least minimize the adverse impact of the rules we have outlined. While we believe that TEFRA's impact on small business was unnecessarily harsh, we commend the Subcommittee for taking the time and making the effort to hear the views of the public and to consider the development of legislation that would correct some of the statutory problems developed in the hurried enactment of TEFRA in the last session of Congress. AALU would be most happy to work with the Subcommittee and its staff to further develop any of the suggestions outlined above or on any other suggestions on which the Subcommittee would like assistance.

Thank you again for this opportunity to submit our views.

Senator **Chafee**. Mr. Holleman, what about your recommendation on page 3, the last one on mandatory age 70½ distribution requirement and penalty for distributions before age 59½ for key employees should be eliminated? That's the same elements we have under the IRA's. Give me your thoughts on why that should be changed.

Mr. **Holleman**. Well, let me speak very directly to the first portion which is those individuals who work beyond age 70. Many small employers work late into their lives, and it seems to me that it's an unnecessary penalty to force them to start their retirement distributions before or at age 70½.

Senator **Chafee**. What date would you recommend? Just when would you have them retire?

Mr. **Holleman**. When they retire.

Senator **Chafee**. What are we dealing with here? Is this retirement income or is this to build up an estate?

Mr. **Holleman**. Oh, I think very clearly it is retirement income. But I think that the plan can deal directly with when that retirement should take place. We have a number of plans. We administer some 800. And some have a normal retirement date of 75. Some have a normal retirement date of 55. And in each instance there would be a penalty.

Senator **Chafee**. Suppose we took your idea? We would have to change IRA's, too? Would you suggest doing that?

Mr. **Holleman**. I would suggest we do that, yes.

Senator **Chafee**. You have got some plans that the retirement age is provided as 75?

Mr. **Holleman**. Yes, indeed.

Senator **Chafee**. I am curious. Who has got that plan? I'm not asking a name. That's a little unusual. Can they retire earlier?

Mr. **Holleman**. There are early retirement privileges in most plans.

Senator **Chafee**. You can get out at 73? [Laughter.]

Mr. **Holleman**. Seventy-three, yes. Oftentimes we have companies who have not had the ability to put in plans until many of the employees are age 60. And they would put in a plan with a normal retirement plan where the age is 75.

Senator **Chafee**. Thank you very much for coming. We appreciate it.

Senator **Chafee**. The last panel is Mr. Duffy, Mr. Philion, and Mr. Sacher. Mr. Duffy, why don't you lead off?

STATEMENT OF HENRY A. DUFFY, PRESIDENT, AIR LINE PILOTS ASSOCIATION, WASHINGTON, D.C., ON BEHALF OF AIR TRANSPORT ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. **Duffy**. Good morning, Senator. I'm Capt. Hank Duffy, president of the——

Senator **Chafee**. Is that mike working?

Mr. **Duffy**. Yes.

Senator **Chafee**. Why don't you speak right into it?

Mr. **Duffy**. I'm Capt. Hank Duffy, president of the Air Line Pilots Association.

Senator **Chafee**. You are not for that 75 retirement age, are you?

Mr. Duffy. We are going to talk to you about a whole different problem. [Laughter.]

We represent the professional interest of some 34,000 airline pilots who fly for 44 airlines in this country.

First, let me thank you for scheduling these hearings so early in the new Congress to review the effect of private retirement plans of the pension provisions contained in subtitle C of TEFRA. I appreciate the opportunity to present to the subcommittee the views of ALPA's members concerning the grave impact of these provisions, which is unique to the pension plans covering commercial pilots.

Section 235 of the law establishes new limits on contributions and benefits for qualified retirement plans by amending Internal Revenue Code section 415. An unintended, yet serious, inequity was created by the section of the 1982 amendments relating to the actuarial adjustments in the defined benefit plan limit for early retirement.

Under prior law, the defined benefit plan maximum benefit was applicable to anyone who retired at or after age 55. This benefit level was reduced for those who chose to retire early, before age 55. TEFRA changed those rules. The maximum benefit is now reduced for anyone who elects early retirement prior to age 62 and begins receiving benefits from a qualified plan. In making this change, the Congress failed to consider a group of employees who are required by Federal regulation to retire prior to age 62—commercial airline pilots.

Pilots are required to retire at age 60. This is most definitely not a voluntary early retirement as it is commonly known in other sections of the economy. This mandatory retirement is required by Federal regulations, FAR-121.383(c), for reasons of public safety. While it may be reasonable to require a reduction in the maximum benefit for those who choose to retire before age 62, it is inequitable to apply this same provision to those who have no such choice.

As TEFRA is currently written the commercial airline pilot may never attain the benefit level available to retirees in other qualified plans. The pilot's reduced benefit is due to reasons completely beyond his control, since his retirement age is federally mandated.

The subcommittee should note that in 1974 when Congress passed ERISA it recognized this unique characteristic of airline piloting as an occupation. A special exclusion with regard to the comparability of plans in applying discrimination tests under Internal Revenue Code section 410(b) was adopted at that time. This exclusion allows plans covering airline pilots to be considered separately, recognizing the pilot's shorter working career which results from the retirement age mandated by the FAA. The same conditions apply here.

Last year, the late Congressman Phil Burton, chairman of the House Subcommittee on Labor Management Relations, which has jurisdiction on ERISA and other pension matters, wrote to the conference committee dealing with TEFRA urging them to address the inequity which leaves pilots squeezed between two well-intentioned Federal requirements.

Unfortunately, time constraints involved in other TEFRA issues did not allow the committee to consider our special situation.

Senator **Chafee**. Let me ask you, Captain, are pilots under a 50 percent of pay retirement or does it vary?

Mr. **Duffy**. It varies. We have 44 different plans out there. The more typical one would be 60 percent of final average earnings, and the AFAE would vary between 3, 4, and 5 years.

Senator **Chafee**. If you are on the 60-percent plan, and you are allowed a $90,000 maximum, you would have to be at over $180,000 to be affected by the reduction.

Mr. **Duffy**. Some of our plans are going out this year, and will bump against the maximum. Here is the problem. The $90,000 limit does not apply to us. It is actuarially reduced because of the 2-year difference between age 62 and age 60, and when you apply the actuarial reduction, our limit is $75,000. And that is exactly our point.

And our people are bumping up against the $75,000 maximum. And the $90,000 that is available to corporate executives——

Senator **Chafee**. My point was that you have got to be at a pretty good salary to be bumping up against the maximum, even with the reduced 2 years.

Mr. **Duffy**. Well, to bump against the $75,000 maximum—and, yes, we do make good salaries. They are collectively bargained at an arm's length relationship at the negotiating table.

Senator **Chafee**. My real point was: Is this a practical matter? It is a practical problem. It is coming to it.

Mr. **Duffy**. On at least three properties where we bargained, we are at the limit this year. Yes, sir.

Senator **Chafee**. Go ahead. I cut you off.

Mr. **Duffy**. We would like to submit Representative Burton's letter as part of this submission.

Senator **Chafee**. That's fine.

[The letter submitted by Mr. Duffy follows:]

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
COMMITTEE ON EDUCATION AND LABOR
SUBCOMMITTEE ON
LABOR-MANAGEMENT RELATIONS
2451 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

August 3, 1982

The Honorable Dan Rostenkowski
U. S. House of Representatives
2111 Rayburn HOB
Washington, D. C. 20515

Dear Congressman Rostenkowski:

Because you will be serving as a member of the Conference Committee on H. R. 4961, the Tax Equity and Fiscal Responsibility Act of 1982, I thought it appropriate to bring to your attention a matter of concern to me.

As you know, H. R. 4961, as adopted by the Senate, makes several modifications in the treatment of qualified pension, profit-sharing, and stock bonus plans under section 401(a) of the tax code. However, because of an apparent oversight certain of the provisions in this legislation will result in unfair discrimination against employees who are required by federal law to retire at an early age.

H. R. 4961 sets new maximum benefit limits under defined benefit plans and allows those maximum benefits to be drawn at age 62. However, for retirement prior to age 62, the new annual benefit limitation would be actuarily reduced so that it is the equivalent of the maximum annual benefit at age 62. While this would seem to be a reasonable requirement, making such a change applicable to employees who do not have the option of working to age 62 because of a federal mandate forcing them to retire earlier would have the effect of imposing an inequitable standard on this category of employee. Not only could this penalize individuals, but it could result in the disqualification of company-wide pension plans and adversely impact thousands of employees. Existing pension law takes this unique situation into account regarding comparability of plans with a specific exclusion for these types of workers in the Internal Revenue Code (Section 410(b)), added by ERISA.

I urge you, during your deliberations in conference on H. R. 4961, to adopt amending language that will clarify this matter and insure that all employees are treated fairly under our pension laws.

Sincerely,

Phil Burton

PHILLIP BURTON
Chair
Subcommittee on Labor-Management
Relations

PB:ff/rmh

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Senator **Chafee**. Why don't you go to your second problem.

Mr. **Duffy**. A second problem is of a technical nature that recently came to our attention. This is an oversight in the effective date provisions of section 235 of TEFRA. Paragraph 4 of this section contains a grandfather provision, preserving benefits accrued under prior law. While TEFRA defers the effective date for collectively bargained plans, it failed to defer the date as of which the grandfather limit is determined. The intent of Congress concerning this provision was indicated on page 291 of the general explanation of the revenue provisions of TEFRA, prepared by the staff of the Joint Committee on Taxation.

That document states that the accrued benefits to be grandfathered is the accrued benefits just prior to the TEFRA data as it affects each collectively bargained plan. This is the correct interpretation, but we are informed by committee that a technical correction to TEFRA will be necessary in order to assure that result.

Therefore, we urge you to make this correction as soon as possible.

Thank you.

Senator **Chafee**. Captain, we understand that this second point you make is as you point out, a technical correction. It is a candidate under the technical correction provisions.

Well, fine. Thank you.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF CAPT. HENRY A. DUFFY, PRESIDENT, AIR LINE PILOTS ASSOCIATION

I am Captain Henry Duffy, President of the Air Line Pilots Association (ALPA). Our Association represents the professional interests of more than 34,000 pilots who fly for 44 airlines.

First, I commend you, Mr. Chairman, for scheduling these hearings so early in the new Congress to review the effect on private retirement plans of the pension provisions contained in Subtitle C of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). I appreciate the opportunity to present to the Subcommittee the views of ALPA's members concerning the grave impact of these provisions which is unique to the pension plans covering commercial pilots.

Section 235 of the law established new limits on contributions and benefits for qualified retirement plans, by amending Internal Revenue Code Section 415. An unintended, yet serious, inequity was created by the section of the 1982 amendments relating to the actuarial adjustment in the defined benefit plan limit for early retirement. Under prior law, the defined benefit plan maximum benefit was applicable to anyone who retired at or after age 55. This benefit level was reduced for those who chose to retire early, before age 55.

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TEFRA changed these rules. The maximum benefit is now reduced for anyone who elects early retirement prior to age 62 and begins receiving benefits from a qualified plan. In making this change, the Congress failed to consider a group of employees who are required by Federal regulation to retire prior to age 62 --commercial air line pilots. Pilots are required to retire at age 60. This is, most definitely, not a "voluntary early retirement", as it is commonly-known in other sectors of the economy. This mandatory retirement is required by Federal Regulations (FAR 121.383(c)) for reasons of public safety.

While it may be reasonable to require a reduction in the maximum benefit for those who choose to retire before age 62, it is inequitable to apply this same provision to those who have no such choice. As TEFRA is currently written, the commercial air line pilot may never attain the benefit level available to retirees in other qualified plans. The pilot's reduced benefit is due to reasons completely beyond his control, since his retirement age is federally mandated.

The Subcommittee should note that, in 1974, when Congress passed the Employee Retirement Income Security Act (ERISA), it recognized this unique characteristic of airline piloting as an occupation. A special exclusion with regard to the comparability of plans in applying discrimination tests (Internal Revenue Code Section 410(b)) was adopted at that time. This exclusion allows plans covering air line pilots to be considered separately, recognizing the pilots' shorter working career, which results from the retirement age mandated by the FAA. The same conditions apply here.

Last year, Representative Phillip Burton, Chairman of the House Subcommittee on Labor-Management Relations, wrote to the Conference Committee dealing with TEFRA urging them to address the inequity which leaves pilots squeezed between two well-intentioned Federal requirements. Unfortunately, time constraints involved in other TEFRA issues did not allow the Committee to

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consider our special situation. With your approval, Mr. Chairman, I would like to include Representative Burton's letter as part of our submission for the record.

Mr. Chairman, Section 235 has a serious adverse affect on ALPA's entire membership. Since the problem is due to two conflicting provisions of public law, we strongly urge the adoption of a correcting amendment to provide that the maximum benefit amount is not to be reduced for the period between age 62 and any earlier retirement age mandated by the Federal government.

A second problem of a technical nature recently came to our attention. This is an oversight in the effective date provisions of Section 235 of TEFRA. Paragraph 4 of this section contains a "grandfather" provision preserving benefits accrued under prior law. While TEFRA defers the effective date for collectively-bargained plans, it failed to defer the date as of which the grandfathered benefit is determined.

The intent of Congress concerning this provision was indicated on page 291 of the General Explanation of the Revenue Provisions of TEFRA, prepared by the staff of the Joint Committee on Taxation. That document states that the accrued benefit to be grandfathered is the accrued benefit just prior to the TEFRA effective date. This is the correct interpretation, but we are informed by committee staff that a technical correction to TEFRA will be necessary in order to assure that result. Therefore, we urge you to make this correction as soon as possible.

Again, on behalf of the Air Line Pilots Association, thank you for the opportunity to present our views, and I will be happy to respond to any questions you might have.

STATEMENT OF NORMAN J. PHILION, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Senator CHAFEE. Mr. Philion, is your testimony different? You are both from ATA?

Mr. PHILION. Mr. Chairman, I represent the Air Transport Association on behalf of virtually all of the airlines of the United States. Captain Duffy represents the pilots that fly our airplanes.

Airline management joins with its pilots in urging this subcommittee to consider that provision of section 235 which affects the retirement of pilots. As Captain Duffy pointed out, for over 20 years a Federal regulation has prohibited pilots who have reached the age of 60 from flying aircraft in commercial service. Accordingly, airline retirement plans applicable to pilots provide normal retirement benefits at age 60.

Senator CHAFEE. Is there any suggestion, and I have no indication that there is, that the FAA is going to change that and increase it?

Mr. PHILION. We don't believe so. We would urge them not to. We think it's a good rule, and we would hope the FAA would maintain it.

In summary, Mr. Chairman——

Senator CHAFEE. Do you agree with that, Captain Duffy?

Mr. DUFFY. Yes, sir, we do.

Senator CHAFEE. I'm sorry, Mr. Philion. Go ahead.

Mr. PHILION. Mr. Chairman, in summary we would urge that you would consider adopting an exemption for those employees who are required to retire before age 62, who are required to retire by Federal law or regulation.

Thank you very much.

Senator CHAFEE. I think you are in a Catch-22 situation, and we appreciate you bringing it to our attention.

Mr. PHILION. Mr. Chairman, I should add one other point. All members of the Air Transport Association endorse the recommendation I have given you except Continental Airlines. Continental has a differing view, and will be making its view known to the subcommittee.

Senator CHAFEE. We never expect any group to come here representing everybody. I am surprised you got as many as you did. We will wait to hear from Continental.

Mr. PHILION. Thank you.

[The prepared statement of Mr. Philion follows:]

PREPARED STATEMENT OF NORMAN J. PHILION, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA

My name is Norman J. Philion. I am Executive Vice President of the Air Transport Association of America, which represents virtually all of the scheduled airlines of the United States. I am accompanied by William M. Hawkins, the Association's Vice President - Finance and Taxation.

We appreciate the opportunity to appear before the Subcommittee during this review of the pension provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Our comments will be directed to a particular provision of that Act which adversely and inequitably affects one group of airline employees — that is, airline pilots. Our member airlines currently have over 300,000 employees in whose behalf they provide a broad variety of benefit plans, including both defined benefit plans and defined contribution retirement plans. The pilots represent over 10 percent of airline industry employment.

The 1982 Act included a number of changes in the limitations applying to pension benefits. One of those changes increased the retirement age from 55 to 62 for retirement without an actuarial adjustment penalty. Although it may not have been intended, this particular change will impact heavily on airline pilots whose retirements at age 60 are mandated by federal regulation.

The increase from age 55 to 62 for a retirement without actuarial penalty was included in the 1982 Act, according to the record, in order to curb abuses and excessive tax deductions. For example, Treasury Department representatives stated that they believed many retirement plans may have established artificially low retirement age provisions for the purpose of accelerating tax deductions. This is not the case with regard to pilot retirement plans. The pilot retirement age certainly is not artificial; it is required by federal regulation.

The Federal Aviation Act of 1958, as amended, imposes upon the Administrator of the Federal Aviation Administration the duty to assure aviation safety. To carry out this duty, the Federal Aviation Act also empowers the Administrator to promulgate regulations applicable to, and minimum standards governing the qualification of, pilots and the operation of civil aircraft. Under this broad authority, over 20 years ago the Administrator promulgated a regulation prohibiting pilots who have reached the age of 60 from flying aircraft in commercial service. The regulation also forbids an airline to use a pilot who is over age 60 to operate its aircraft. This regulation — 14 CFR 121.383(c) — reads as follows:

> "No certificate holder may use the services of any person as a pilot on an airplane engaged in operations under this part if that person has reached his 60th birthday. No person may serve as a pilot on an airplane engaged in operations under this part if that person has reached his 60th birthday."

In recognition of this federal regulation, airline retirement plans applicable to pilots have been developed over the years to provide normal retirement benefits at age 60. The 1982 Act, by increasing the early retirement age for pension purposes, took no account of the federally mandated retirement age for airline pilots and this, in our opinion, unjustifiably results in a reduction in their retirement benefits. Thus, there is a conflict in public policy.

Congress has previously recognized the unique retirement requirement applicable to airline pilots. It did so, for example, when the Employee Retirement Income Security Act of 1974 was adopted. This Act excluded pilot pension plans from the normal discrimination tests used to determine qualified plans, in recognition of the federally mandated pilot retirement at age 60.

The airlines believe that the pension laws should not require a reduction in pilot pension benefits when airline pilots are required by federal regulation to retire at age 60. We respectfully urge, therefore, that this TEFRA limitation provision be amended to permit airline pilots to receive the full retirement benefits otherwise available to all other employees at age 62. This could be accomplished by incorporating an exemption for those employees who are required to retire before age 62 by federal law or regulation.

Favorable consideration of this request would be deeply appreciated by the airlines.

Senator CHAFEE. Mr. Sacher.

STATEMENT OF CHARLES P. SACHER, ESQ., WALTON, LANTAFF, SCHROEDER & CARSON, CORAL GABLES, FLA., ON BEHALF OF THE SOUTH FLORIDA EMPLOYEE BENEFITS COUNCIL, MIAMI, FLA.

Mr. SACHER. Good morning, Senator. I would like to thank you for giving me the opportunity of testifying here today. My name is Charles P. Sacher. I'm a practicing attorney in Coral Gables, Fla.

I'm testifying in my capacity as the past president of the South Florida Employee Benefits Council, and on behalf of the approximately 32,500 individuals who participate in the private pension plans sponsored by the clients of our members.

These plans presently own approximately $500 million in assets, and have annual contributions of approximately $70 million. I have prepared and submitted a formal written statement. I will highlight the points contained in this statement in my testimony.

Unlike Dr. Schieber, and like Mr. Paley, we are on the firing line, and we have actual information with respect to the effect of certain pension provisions presently enacted by the Tax Equity and Fiscal Responsiblity Act. We have determined that these provisions will result in the curtailment or termination of a substantial number of plans thereby adversely affecting more than 17,500 of our participants, and reducing the annual retirement savings by approximately $40 million.

The employers represented by our members are almost exclusively small businesses in which the owners work. These owners use their energies and efforts to earn an income sufficient to provide for their current needs and to set aside retirement savings for themselves and their employees.

Certain provisions of the Tax Equity and Fiscal Responsibility Act impacts small businesses in a discriminatory and unjustifiable manner which reduce the opportunity, ability, and incentive to provide these retirement savings and benefits.

Implicit, in many of these provisions is a feeling that there is something inherently wrong with savings for retirement. We disagree with that.

Senator CHAFEE. Wait a minute. I'm not prepared to concede that that is inherent in TEFRA. Go ahead.

Mr. SACHER. These savings accomplish specific goods and should be encouraged rather then discouraged. They provide funds for capital formation and economic recovery. They also provide significant retirement benefits which relieve the strain on our social security system. We believe that any suggestion that a reduction in retirement savings will result in an increase in tax revenues is wrong. These lost retirement saving dollars will probably go into tax shelters, some of which will be abusive, which are not economic, which are not beneficial, and which will be to the detriment of the investors, their employees and the country.

The pension provisions which have the most substantial impact on the small businesses are the so-called topheavy plan rules, the limitation on existing defined benefit plans, and the restriction on certain personal service corporations.

The topheavy plan rules which have been discussed today impose greater requirements on plans in which the owners enjoy more than 60 percent of the benefits. These rules, as you have heard, generally increase the owner cost of maintaining the plan. However, the so-called super topheavy rules apply in those situations in which more than 90 percent of the benefits belong to the owners.

This limitation on these benefits applies even though full benefits are provided to all other employees. This is not a case where there is no comparable coverage or full benefits. There is an absolute prohibition in a super topheavy plan to the maintenance of the 1.25 combination of plan rules. There is nothing that a small business can do about that. If they are unable because of the size of the work force, because of the age of the work force, because of the turnover, or whatever reason to provide 10 percent or more benefit for rank and file employees, they simply cannot have a second plan. They are limited to the one plan and not the 1.25 plan.

There is no justification for this disparate treatment. These small businesses should be afforded the small pension benefits as larger businesses so long as they provide comparable and nondiscriminatory benefits to all their employees.

A related problem to the small business is the limitation on further contributions to existing defined benefit plans. Such plans which were being funded at higher permissible pension levels for a permissibly earlier retirement age are not effectively finished or substantially curtailed. These curtailments and terminations will adversely affect tens of thousands of employees in south Florida, and probably millions of employees throughout the country. This result can be avoided by permitting existing plans to continue without further contributions, if the plans assets and future benefits are not considered in calculating the pension limitations for any successor plan which meets the new requirements.

Finally, I would like to address section 269(a), which one of the earlier speakers addressed. This provision, although characterized as a pension law, is not that at all. It was simply an attempt to overrule a tax court case changing the rules of the Internal Revenue Service that had existed for 20 years.

Mere compliance with the pension provisions which were enacted in section 415(m) brings into doubt the validity of these personal service corporations.

In conclusion, we ask the subcommittee to consider repealing what we consider to be onerous provisions affecting small businesses, or at a minimum to recommend the delay in the effective date, so that further studies can be made to determine the real impact on retirement savings from these changes.

Thank you very much.

Senator CHAFEE. Thank you very much, Mr. Sacher. We appreciate that.

[The prepared statement of Mr. Sacher follows:]

PREPARED STATEMENT OF CHARLES R. SACHER, PAST PRESIDENT, WALTON, LANTAFF, SCHROEDER, & CARSON, ON BEHALF OF THE SOUTH FLORIDA EMPLOYEE BENEFITS COUNCIL

April 8, 1983

The Honorable Robert Dole
Chairman, Senate Finance Committee
2213 Dirksen Building
Washington, D.C. 20510

BY FEDERAL EXPRESS DELIVERY

Re: §§235 to 250
Tax Equity and Fiscal Responsibility Act of 1982

Dear Senator Dole:

I write in my capacity as the Past President of the South Florida Employee Benefits Council to submit this Statement in connection with my oral testimony at the public hearing scheduled for April 11, 1983, on the Pension provisions of the above-referenced Act.

The South Florida Employee Benefits Council is a membership organization comprised of individuals and companies whose primary business involves private pension plans. We have sixty-five members, including attorneys, certified public accountants, plan administrators, plan consultants, actuaries, insurance salesmen and trust officers.

The membership of the organization has unanimously approved my testifying and presenting this Statement. This organization respectfully requests that you and your Committee consider the facts set forth in this Statement and recommend the modification of certain pension provisions of the above-referenced Act.

The members of the South Florida Employee Benefits Council who responded to a request for information have indicated that the total value of the assets in the plans sponsored by their clients exceed $500,000,000 and that annual contributions to such plans are in excess of $70,000,000. There are more than 1,700 plans sponsored by such clients and more than 32,500 employees participate therein. Almost 100% of these plans are sponsored by small businesses and will be subject to the "top heavy" plan rules which become effective for plan years beginning in 1984. Consideration is being given to the curtailment or termination of a substantial number of defined benefit plans. When the pension provisions of this Act become fully effective, we estimate that more than 900 of these 1,700 plans will be terminated or curtailed and more than 17,500 of the 32,500 participants will have their pension benefits either eliminated or substantially reduced. The elimination or curtailment of these plans will substantially reduce or eliminate the pension benefits for a tremendous number of rank and file employees (approximately 14,000 of the 17,500 effected participants are rank and file employees). Equally important, the annual contributions to these plans will be reduced by more than $40,000,000 resulting in a reduction in funds for the following sources: savings and loan associations for mortgage investments; capital stock purchases for capital formation; corporate bonds for capital formation; and direct mortgage loans for residential construction. The impact on the rank and file employees, the loss in capital formation dollars and the long-term adverse impact on the Social Security system demand modification in the following pension provisions of the Tax Equity and Fiscal Responsibility Act:

OBJECTIONABLE PENSION PROVISIONS

The specific pension provisions of the Internal Revenue Code amended or added by the Tax Equity and Fiscal Responsibility Act of 1982 which the members of the South Florida Employee Benefits Council specifically oppose are:

1. I.R.C. §415(j)(4) limiting defined benefits for existing plans to the participant's "current accrued benefits";

2. I.R.C. §416(c)(1) requiring the provision of minimum benefits for participants in a top heavy defined benefit plan;

3. I.R.C. §416(h)(1) limiting the benefits available to key employees in certain top heavy plans to the benefits provided by one plan;

4. §269A granting the Secretary of the Treasury the authority to allocate income and deductions in the case of certain personal service corporations.

GENERAL REASONS FOR OPPOSITION

We feel that the pension provisions described above should be modified, repealed or at least delayed for further study, for the following general reasons:

A. These pension provisions will substantially reduce the benefits for rank and file employees in private pension plans sponsored by small businesses to the detriment of these employees in particular, and the economy and the federal government in general.

B. These pension provisions will have an adverse impact on the economic recovery of this country:

1. The inflow of capital formation dollars into the economy will be substantially reduced;

2. These provisions are directly contrary to the philosophy of the Economic Recovery Tax Act of 1981 which was intended to foster rather than stifle economic recovery through encouraging capital formation;

3. The federal budget deficit will be increased rather than decreased;

a. The reduction in income tax revenues resulting from the reduced income associated with the further economic downturn will exceed the anticipated increase in income tax revenues expected from the reduction in deductions for contributions to pension plans;

b. The anticipated increase in income tax revenues will not occur because the reduced pension contributions will be offset by salaries or other compensatory-type payments and increased use of tax shelters;

c. Government welfare expenditures will grow as more and more people lose their jobs as the economic downturn worsens.

C. These pension provisions will increase dependence on our nearly bankrupt Social Security system;

1. We estimate that approximately 17,500 plan participants in the South Florida area will have their benefits curtailed or lost completely if these pension provisions become effective;

2. Any measurable decrease in private pension benefits, particularly for rank and file employees, will have a catastrophic effect on such participants' ability

to cope with the devastating effect of inflation and will place further strains on the Social Security system.

D. These pension provisions discriminate against small business and, in particular, certain personal service businesses at a time when small businesses, and particularly personal service businesses, provide the lifeblood of the economy of this country.

We believe that the foregoing general reasons constitute good and sufficient, if not conclusive, reasons why you and your Committee should recommend legislation to repeal the pension provisions described above. However, we also have specific reasons addressed to each of these pension provisions.

SPECIFIC REASONS FOR REPEALING SELECTED PENSION PROVISIONS

The limitations of I.R.C. §415(j) should be repealed for the following reasons:

1. The effect of I.R.C. §415(j) will be to reduce benefits under existing defined benefit plans to the reduced dollar limitations and will result in the elimination of contributions to these plans for a number of years or permanently.

2. The reduction in the maximum defined benefit accompanied by the increase in the earliest normal retirement age while taking into account the full value of assets currently in defined benefit pension plans should be repealed so as to avoid the curtailment or termination of a substantial number of defined benefit pension plans to the detriment of all participants therein. Many plans were set up with automatic increases in the maximum defined benefit or were amended annually to increase the defined benefit as permitted by existing law. These automatic adjustments resulted in substantial monies being accumulated under defined benefit pension plans. All participants in the plans were entitled to and expected to receive benefits at the levels set forth in the plan. The use of the existing assets to project the future benefit will, in many instances, eliminate or substantially reduce all future contributions for the owners who sponsor these plans. The elimination of any future benefit under these plans will in most instances prompt the sponsors thereof to terminate or otherwise curtail the plans and thereby eliminate or substantially reduce the benefits that all employees will derive from these plans.

3. The well-thought-out provisions of the Employee Retirement Income Security Act of 1974 permitted owners of

small businesses to structure their financial and retirement plans to take into account the future contributions and prospective benefits that they would enjoy under a defined benefit pension plan. The combined effect of the reduction in benefits and the increase in the earliest normal retirement age will substantially and adversely affect all of these owners who have structured their affairs in accordance with existing law and now find that that law has deprived them of benefits to which they were fully entitled under existing law. It is patently unfair to penalize a person who merely complied with existing law by taking the funds accumulated under the permissible provisions of existing law and using those funds to deny such individuals the opportunity to fund for their retirement even under the reduced limitations of the new law. This provision effectively and permanently eliminates the opportunity for many owners who, through their own efforts and managerial expertise, were able to generate sufficient income in their businesses to provide for their own retirement and the retirement of their employees to continue to provide for this retirement even within the reduced limitations of the new law.

The provisions of I.R.C. §416(c)(1) should be repealed for the following reasons:

1. I.R.C. §416(c)(1) requires a minimum accrual of benefits at the rate of either 2% a year for ten years or 20%. Thus, a participant who upon completing ten years of service with an employer who is subject to the top heavy plan rules will be irrevocably entitled to a 20% benefit upon attaining normal retirement age. If that employee were to transfer jobs to another employer subject to the top heavy plan rules, he would be entitled to earn an additional 20% benefit. Should that same participant change jobs a third time and obtain employment with an employer subject to the top heavy plan rules, he would be entitled to a third 20% benefit. Therefore, at the completion of no more than thirty years of total employment, the participant would be entitled to a 60% benefit or three times the minimum benefit prescribed by the new law. This result is reached because there is no provision under the existing law to permit a subsequent employer to take into account the benefits that have already been funded by a prior employer. Thus, the new law effectively provides a minimum 60% benefit by not permitting crediting for prior benefit accruals.

2. The provisions of this I.R.C. §416(c)(1) requiring the accrual of benefits over a ten year period rather than over the period of participation or service as permitted under I.R.C. §411(b)(1)(C) constitute a substantial change in the pension laws, affecting only small employers. Typically, the

accrual of a benefit under a defined benefit pension plan takes into account either years of participation or years of service or a combination thereof. §411 of the Internal Revenue Code as added by the Employee Retirement Income Security Act of 1974 set forth minimal accrual rules which were deemed sufficient to protect rank and file employees against delayed accruals which would be geared to the employment or participation history of the owners. No rules have ever provided or required accrual within ten years. The typical accrual rule is 3% per year. Thus, if the 3% rule were applied to the accrual of minimum benefits, the participant with ten years of service would have accrued a 30% right to his 20% benefit or, upon retirement, after completing only ten years of service, would be entitled to a benefit of 6% from that employer. Thus, if the subsequent changes of jobs as illustrated above were to continue, the participant would be entitled to an 18% benefit which would be in the range of what the new law requires. Thus, this Section should be repealed or amended to permit the normal accrual rules to apply to the 20% benefit rather than requiring the accrual thereof over a ten year period. Question and Answer M-5 in the Proposed Regulations published in the Federal Register on March 15, 1983, at page 10875 specifically provides that the rule of I.R.C. §411(b)(1)(C) will not be applicable.

3. The expense of providing the 20% benefit for an individual over a short period of time will effectively preclude the employment of older individuals in defined benefit plans subject to this top heavy rule. The cost of funding a 20% benefit for a 55-year old individual is substantially greater than the cost of funding the exact same 20% benefit for a 35-year old individual. Thus, it is unlikely that the older individual will be employed simply because the cost of providing this benefit is excessive. This cost could be reduced if the normal accrual rules of I.R.C. §411 were applicable so that the accrual of benefits and therefore the cost would be determined in accordance with the provisions of the plan and not arbitrarily established by the top heavy plan requirements.

The provisions of I.R.C. §416(h)(1) should be repealed for the following reasons:

1. I.R.C. §416(h)(1) limits the opportunity for an owner of a small business to sponsor and participate in more than one plan if the owner's total account balances and accrued benefits under the plans exceed 90%. This prohibition applies regardless of the level of benefits provided for rank and file employees. This particular provision is particularly discriminatory against small businesses because it does not take into account the possible reasons why the business cannot provide additional

benefits for the rank and file employees. The composition of the rank and file work force may effectively prevent the accrual of benefits in excess of 10% regardless of the actions or desires of the employer. Thus, a small business in which the owner wants to afford employment to younger workers, particularly those in the work force where there is presently 20-25% unemployment, would be prejudiced by the application of this rule. He could not obtain the benefits available to all other owners in small businesses which have a work force with higher average age or which have a sufficient number of employees to insure that that 10% threshold is met.

2. The prohibition against participation in more than one plan is not predicated on any showing of discrimination against rank and file employees or any objective finding that owners of businesses which are not labor intensive are not entitled to the same benefit as the owners of businesses which are more labor intensive or which have a more dispersed ownership pattern so that they do not fall within the top heavy plan rules. There is no reason to deny to owners of very small corporations, even those which have only the owner as an employee, including sole proprietorships, the right to enjoy exactly the same plan benefits as those provided to businesses with a larger work force or more dispersed ownership.

3. This one provision alone epitomizes and embodies the discrimination inherent in many of the pension provisions of the Tax Equity and Fiscal Responsibility Act of 1982 against small businesses. The owners of small businesses use their time and talents to generate income and pay tax thereon. They have no alternative but their own efforts to provide for their retirement. The curtailment of this retirement benefit simply based upon the happenstance of the size of the work force is discriminatory and unjust. Owners of small business should have exactly the same right to plan for and fund his retirement as that available to any other participant in a private pension plan system.

§269A of the Internal Revenue Code should be repealed for the following reasons:

1. I.R.C. §269A of the Internal Revenue Code was added in the waning moments of the Conference Committee's deliberation without any opportunity for public comment. This Section further epitomizes the discrimination against small businesses. The legislative history reflects that this Section was added to overrule a Tax Court decision which approved the general tax concept of the partnership of personal service corporations. This Tax Court decision was neither new nor revolutionary and,

in fact, merely sustained the position of the Internal Revenue Service, as announced in both public and private rulings, that the utilization of a corporation as a partner was perfectly acceptable from a tax point of view. Thousands and thousands of individuals organized their business affairs in reliance on existing tax law only to find that without the benefit of any public hearings whatsoever, their businesses are now subject to unusual and potentially devastating scrutiny by the Internal Revenue Service without any finding at all that the utilization of those businesses is objectionable, is based upon any attempt to evade or avoid taxes or any other non-legitimate reason.

2. The defect of I.R.C. §269A in the pension area is particularly apparent when the legislative history of I.R.C. §414(m) is considered. I.R.C. §414(m) was specifically enacted to provide detailed pension rules for the businesses which are the subject matter of I.R.C. §269A. I.R.C. §414(m) was added in December, 1980, to correct a perceived abuse in the pension area in the utilization of a partnership including personal service corporations. Regulations were only recently imposed under I.R.C. §414(m). There is absolutely no indication in I.R.C. §269A that following the new pension rules as established in I.R.C. §414(m) will be deemed sufficient by the Internal Revenue Service to avoid the impact of I.R.C. §269A. Even the regulations under I.R.C. §416 proposed on March 15, 1983, recognize the impact of I.R.C. §414(m). Thus, the obvious answer is that the pension rules were not deemed important in counting this attack against the partnership of personal service corporations.

3. The legislative history of §269A indicates that it should not be applied during 1983 because of the utilization of any form of pension plan. Implicit in this provision is that the pension plan area could be considered in determining whether or not the personal service corporation was formed or availed of for a prescribed purpose in 1984 or later. This would be completely contrary to the provisions of I.R.C. §414(m) and totally discriminatory insofar as the owners of these personal service corporations are concerned if they are providing the pension benefits as required by I.R.C. §414(m) and the Tax Equity and Fiscal Responsibility Act.

4. Enactment of I.R.C. §269A is a further indication of the lack of concern for the stability of business entities evidenced by regular and constant changes in the tax law. The utilization of personal service corporations in the context of a partnership or as contracting entities with other entities was an approved form of doing business for more than 25 years before I.R.C. §269A was enacted. The principal or perceived

abuse during that 25 year period was in the pension area and that abuse was overcome by legislation. Scarcely two years after the pension legislation became fully effective, the entire concept was put into doubt. There was no good and sufficient tax reason for the enactment of I.R.C. §269A and it should be repealed.

5. As an alternative, I.R.C. §269A should be amended to specifically provide that the establishment and utilization of qualified deferred compensation plans in compliance with the provisions of I.R.C. §414(m) will not constitute an act of evasion or avoidance of tax to justify the imposition of the penalties of I.R.C. §269A to these personal service corporations.

DELAY IN EFFECTIVE DATES RATHER THAN REPEAL

The members of the South Florida Employee Benefits Council believe that the foregoing general and specific reasons amply justify a vote to repeal the specific pension provisions described above. However, even if a repeal of these provisions is not deemed appropriate at this time, it is certainly appropriate to delay their effective date for further study and comment. The "top heavy" plan rules are scheduled to go into effect in 1984, and many plans are being curtailed or terminated and all have to be amended prior to 1984. The immediate delay of the effective date of these provisions to 1985 is certainly justified in light of the substantial detriment to rank and file employees which will be occasioned by the implementation of the top heavy plan rules in their present form. Similarly, the combination of the limitations on the defined benefit pension plans and the elimination of contributions is presently resulting in the curtailment and termination of a substantial number of defined benefit pension plans. The full impact of these curtailments and terminations on rank and file employees cannot be known at this time and the provisions of I.R.C. §415(j)(4) as they apply to defined benefit pension plans in existence on July 1, 1982, should be delayed until further studies can be made regarding the impact on rank and file employees from such terminations and curtailments. The provisions of I.R.C. §269A should be delayed until adequate studies can be made regarding the types of potential tax abuse and the effective date of I.R.C. §269A should be delayed until these studies can be completed and I.R.C. §269A can be structured so as to deal specifically with the potential abuses of the use of these personal service corporations rather than to foster the uncertainty of the uncontrolled and unbridled authority of the Secretary of the Treasury being brought to bear on the owner of a personal service corporation who is otherwise fully complying with all pension and other laws respecting the formation and operation of his personal service corporation.

Thank you for your attention to this matter.

Senator **Chafee**. I want to thank each of the panelists for coming.

Let me ask you this, Mr. Sacher. Do you think that if we try to straighten out some of those problems that have been pointed out here that we would find a conflict between various groups from the, say, large employers versus small employers, from those that are dealing with greater accent on profit sharing plans? Are we going to get into a problem where there is a good deal of conflict between the various proponents of change?

Mr. **Sacher**. Not necessarily, Senator. The greatest problem you have heard today is about the topheavy plan rules. I think unanimously the proponents of ERIC, large corporations and small businesses object to the topheavy plan rules. I know that there would be some conflict if the minimum benefit accelerated vesting was to be applied across the board. That is an area of conflict.

Two of the speakers pointed out that there are restrictions that are applicable to small businesses. If it is determined necessary to maintain minimum benefits and accelerated vesting in a small business context, speaking on behalf of my organization and my clients, I don't object to that. My clients basically provide far greater benefits than these minimums presently provided. We provide significant benefits to the participants in the south Florida area. We have accelerated vesting.

So that would not be a problem to us. The problem is that we are just treated differently because we are small, and I see no justification for that. I did not address many of the other provisions—the estate tax exclusion, the 415 limitations. I think those are policy matters. If Congress determines that a $100,000 exclusion is sufficient that is what Congress determined. They've determined that the limits that they set in 1974, which have gradually increased to almost double because of the cost of living, are too high, that's a policy matter.

Senator **Chafee**. One of the prior witnesses was suggesting the full taxation of the benefits at age 70½ or you must take out your benefits by then or you can't take them out prior to 59½. What do you think of that suggestion?

Mr. **Sacher**. Well, the 59½——

Senator **Chafee**. Let's not argue with that one.

Mr. **Sacher**. Seventy and a half. I think there should be an encouragement to take money out. I don't see any justification in the accumulation of funds in corporate plans. That was certainly not permitted in Keogh plans. It's not permitted in IRA's. And if these are retirement moneys that are being set aside during high income years to provide a benefit for retirement years, I think that that particular limitation is appropriate.

Senator **Chafee**. In other words, it is a retirement plan.

Mr. **Sacher**. I certainly hope so.

Senator **Chafee**. All right. Thank you all for coming. We appreciate it.

[Whereupon, at 12:16 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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May 27, 1983

The Honorable John H. Chafee
Chairman, Subcommittee on Savings,
Pensions and Investment Policy
Senate Finance Committee
Dirksen Building
Washington, DC 20510

April 11, 1983 Subcommittee Hearings on TEFRA

Dear Mr. Chairman:

It is the policy of the American Bar Association that self-employed individuals should be subject to the same treatment as employees of corporations with respect to both qualified deferred compensation plans and fringe benefits for federal income tax purposes. A copy of the Association Resolution embodying this position is attached as Appendix A.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) changed the treatment of qualified plans to provide substantial equality of treatment to self-employed persons with respect to such plans. TEFRA did not, however, address parity in the taxation of fringe benefits outside the qualified plan area. TEFRA also failed to address the need to simplify the Internal Revenue Code and the administration of the tax laws relating to parity of treatment in the qualified plan area.

In an effort to assist the subcommittee on Savings, Pensions and Investment Policy, I will briefly outline the areas which should be dealt with to accomplish this parity of treatment.

1. Fringe Benefits. The following provisions of the Internal Revenue Code of 1954 contain rules which should be amended to provide equality of treatment to self-employed individuals as to statutory fringe benefits.

(a) Group term life insurance; I.R.C. Section 79.
(b) Compensation for injuries of sickness; I.R.C. Section 104(a).
(c) Accident andhealth plans; I.R.C. Sections 105(g) and 106.
(d) Qualified transportation; I.R.C. Sections 124(c)(1) and 124(d)(2).
(e) Cafeteria plans; I.R.C. Section 125(e).
(f) Gifts and awards; I.R.C. Sections 274(b) and 274(b)(3).
(g) Employees' beneficiary associations; Treas. Reg Section 1.501(c)(9)-2(a)(1).

In urging equality of treatment of self-employed persons and corporate employees in these statutory provisions, the American Bar Association is not taking a position that any or all of these provisions should necessarily be retained in their present form. We address only the matter of difference in treatment of self-employed persons and corporate employees.

2. Treatment of Qualified Plan Deductions. TEFRA repealed I.R.C. Section 401(j). It was intended that partnerships and proprietorships would be able to adopt defined benefit plans under the rules applicable to corporations. TEFRA did not change the treatment of deductions for contributions to qualified plans covering self-employed individuals. Specifically, I.R.C. Section 62(7) contemplates that the deduction for a qualified plan contribution passes directly through to the self-employed individual to whom the contribution relates. Treas. Reg. Section 1.404(e)-1A(f)(2) is ambiguous -- it can be read to allow the partners to allocate the deductions for contributions to a qualified deferred benefit plan on behalf of self-employed individuals in a manner permitted under I.R.C. Section 704 to reflect economic reality or it can be read to require that the deduction be allocated in accordance with each partner's percentage of taxable income. Either result conflicts with I.R.C. Section 62(7) and, thus, a clarification is needed. More importantly, I.R.C. Section 62(7) and the latter reading of Treas. Reg. Section 1.404(e)-1A(f)(2) preclude an approach which would reflect "economic reality" under partnership allocation rules. This problem is further confused by the enactment of I.R.C. Section 401(c)(2)(A)(v) which presumably contemplated an I.R.C. Section 62(7) type allocation as opposed to one made under the latter reading of Treas. Reg. Section 1.404(e)-1A(f)(2) or a

traditional "economic reality" allocation. The construction of I.R.C. Section 401(c)(2)(A)(v) will have a direct impact on the calculation of a self-employed individual's earned income for qualified plan purposes. Thus, continuing the limitation contained under I.R.C. Section 62(7) produces an unintended result and it, I.R.C. Section 404(c)(2)(A)(v), and Treas. Reg. Section 1.404(e)-1A(f) should be amended to be consistent and to allow an aggregate qualified plan deduction to be allocated among self-employed individuals under general partnership expense allocation rules to reflect economic reality.

3. Self-Employment Taxes. I.R.C. Section 401(c)(2)(A) was amended by TEFRA to add a subsection (v). This amendment reduces a self-employed individual's "earned income" by the deduction allowed to him under I.R.C. Section 404 or 405 (c). This change flows through to the deduction limits, the I.R.C. Section 415 limits and the new top-heavy provisions. See I.R.C. Section 404(a)(8)(B), 415(b)(3), 415(c)(3)(B), and 416(i)(3)(B). If this adjustment is to be made in computing "earned income" for qualified plan purposes, I.R.C. Section 1402 should be amended to exclude it for purposes of computing net earnings from self-employment with regard to the self-employment tax imposed under I.R.C. Section 1401. This change should be made only to the extent such amounts would not be subject to F.I.C.A. taxes if the self-employed individual were an employee.

4. Qualified Plan Issues. (a) Limits Attributable to Earned Income. To be deductible under I.R.C. Section 404, a contribution must satisfy the conditions of either I.R.C. Section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income). Satisfying one to these conditions is presumed to the extent contributions to a qualified plan on behalf of a self-employed individual (excluding any portion thereof allocable to the purchase of life, accident, health or other insurance) do not exceed his earned income derived from the trade or business. See I.R.C. Section 404(a)(8)(C). Since the contribution to a defined benefit plan for an older self-employed individual could often exceed his traditional earned income, this amendment (discussed in 3), will in many cases effectively preclude the implementation of a defined benefit plan. This result was not intended, and this limitation of Section 404 (a)(8)(C) should be eliminated.

(b) Special Rules re Contributions for Annuity, etc., Contracts. I.R.C. Sections 401(e) and 415(c)(7) have been retained. With the repeal of the deduction limitations set forth in I.R.C. Section 404(e) and the excise tax sanctions under I.R.C. Section 4972, there does not appear to be any reason to retain I.R.C. Section 401(e). At a minimum it needs to be revised to delete the references to I.R.C. Section 4972(b) (effective for taxable year beginning after December 31, 1983) and to increase the dollar limitation to a moving amount which would satisfy the requirements of I.R.C. Section 415(b) and (c). Preferably, I.R.C. Section 415(e)(7) should be amended to include the applicable language of I.R.C. Section 401(e) to allow contributions to be made to maintain the sanctioned contracts on an owner-employee who has no earned income in a particular year.

(c) Deduction Limitations. I.R.C. Section 404(a)(9) is retained. The reference to subsection (e) in I.R.C. Section 404(a)(9)(C) will be meaningless in years beginning after 1983. Likewise, there does not appear to be any policy reason to retain the separate calculations called for in I.R.C. Sections 404(a)(9) (A) and (B) nor to preclude the contribution carry forward provided for under the second sentence of I.R.C. Section 404(a)(3). I.R.C. Section 404(a)(9) should be repealed.

(d) Contributions to Purchase Life, Accident, Health or Other Insurance. Contributions on behalf of self-employed individuals may not be used to purchase life, accident, health or other insurance. See new I.R.C. Section 404(e) and I.R.C. Section 404(a)(8)(C). Parity requires that these rules be eliminated and brought into tandem with the rules applicable to employees covered by corporate plans. Correlative changes will be required in I.R.C. Sections 72(m)(2) and (3).

(e) Net Operating Loss Limitations. TEFRA intended that the opportunity for self-employed individual or a partnership to establish a corporate defined benefit plan would be a meaningful one. This opportunity will, however, likely have limited utility in many situations because of the limitations of I.R.C. Sections 172(d)(4)(D), 401(c)(2)(A)(v), 404(a)(8)(C), 62(7), 702(a)(7), and Treas. Reg. Section 1.404(e)-1A(f). The repeal of the deduction limitations under I.R.C. Section 404(e) was intended to allow the implementation of meaningful defined benefit plans. This will not be possible until these sections are modified to accommodate the major thrust of TEFRA. The interplay of these provisions require that the actual contribution made on behalf of a self-employed individual be passed through to him. See 2. Because of the limitations contained in I.R.C.

Section 172(d) (4)(D) (pertaining to net operating losses) and I.R.C. Section 404(a)(8)(C) (pertaining to the I.R.C Sections 162 and 212 issue (see 4(a)), it will be extremely difficult in many cases to cover older self-employed individuals under defined benefit plans.

(f) Aggregation Rules. I.R.C. Sections 401(d)(9) and (10) have been retained as I.R.C. Sections 401(d)(1) and (2). These rules require aggregation for qualification purposes of all unincorporated trades or businesses controlled by owner-employees who own more than 50 percent of either the capital or profits interest in such trades or businesses. They also prohibit an owner-employee from participating in the plan of a trade or business which he does not control unless he maintains a comparable plan or plans for the employees of those trades or businesses he controls. These rules are more restrictive under some circumstances than their counterparts in I.R.C. Section 414(c), (m), and (n), and it is submitted that the opportunities for abuse in this area do not justify the additonal complexity which is continued by their retention. Further, the retention of these special rules creates a continued incentive to incorporate that parity sought to alleviate. Section 401(d)(1) and (2) should be eliminated.

(g) Lump Sum Distributions. I.R.C. Sections 402 and 403 continue a series of distinctions pertaining to employees and self-employed individuals covered by qualified plans which should be eliminated. For example:

(i). Under I.R.C. Sections 402(a)(2) (last sentence) and 403(a)(2), a self-employed individual must make an election under I.R.C. Section 402(e)(4)(B) to receive capital gain treatment on the pre-1974 portion of a lump sum distribution. This is not required of an employee.

(ii). Under I.R.C. Section 402(e)(4)(A)(iii) a self-employed individual can not satisfy the requirements for a lump sum distribution as a result of a "separation from service." It should be possible to make such determinations on a facts and circumstances basis.

(iii) Under I.R.C. Section 402(e)(4)(A)(iv), only a self-employed individual may qualify for a lump sum distribution as a result of a disability.

(vi). Under I.R.C. Section 402(e)(4)(B), an individual may only make one election to treat a distribution as a lump sum distribution after he has attained age 59½. This rule, coupled with the rule explained in (ii), above, effectively limits self-employed individuals to one lump sum distribution, except in the event of death or disability.

(h) Rollovers. TEFRA did not remove the limitations on roolovers from H.R. 10 plans to corporate plans either directly or through an I.R. A. See I.R.C. Section 402(a)(b)(E)(ii). For years after 1983, there is no reason for this rule and it should be eliminated in the interest of simplicity and parity.

(i) Loans. Although most of the rules regarding participant loans from qualified plans were brought into tandem, loans to "owner-employees" are still effectively prohibited because such loans constitute prohibited transactions under I.R.C. Section 4975 (d) and ERISA Section 408(d). These distinctions should be eliminated.

I hope that this letter can be printed as part of the record of the April 11 hearing. In any case, I hope that it will be helpful to your Subcommittee in its work.

I am authorized to advise that these are also the views of the Standing Committee on Retirement of Lawyers of the Association.

Very truly yours,

M. Bernard Aidinoff
Chairman, Section of Taxation
American Bar Association

The American Bar Association is firmly committed to the objective embodied in the following outstanding resolution of the Association:

> BE IT RESOLVED, That the Internal Revenue Code of 1954 should be amended by eliminating all differences in treatment of self-employed persons with respect to qualified employee benefit plans and all other employee benefits; and
>
> BE IT FURTHER RESOLVED, That at the least, the limitations on contributions to, or benefits from, qualified employee benefit plans should be the same for both employees and self-employed persons and should provide for adjustments for increases in the cost of living as is presently provided with respect to plans for employees.

American Council of Life Insurance

1850 K Street, N.W.,
Washington, D.C. 20006
(202) 862-4000

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY OF THE SENATE FINANCE COMMITTEE

April 11, 1983

The following statement is submitted on behalf of the American Council of Life Insurance ("ACLI"), a national trade association representing 572 life insurance companies. These companies account for 95 percent of the life insurance in force in the United States, hold 95 percent of the assets of all life insurance companies, and hold 99 percent of the reserves for insured pension plans.

Comments

The ACLI is pleased to have this opportunity to present its views on the effects of TEFRA's pension provisions before the Subcommittee on Savings, Pensions and Investment Policy. Like your Chairman, Senator Chafee, the life insurance industry has a great interest in assessing how the changes in TEFRA will impact on the future growth of the private pension system and the ability of Americans to increase their personal savings for retirement. The life insurance business supports measures to strengthen the private employee benefit system so that it may better fulfill its role of providing for the retirement and financial security of American workers and their families. We encourage the growth of this system--to cover additional employees and improve benefits under existing plans. However, while we support the Subcommittee's efforts in this regard, the ACLI believes it is simply too early for us to make any meaningful comments on the actual effect of the TEFRA pension rules.

As the Subcommittee is aware, TEFRA has been in place for less than a year. In the pension area, rules relating to one major issue--"top heavy" plans--have not yet gone into effect. (The "top heavy" rules are effective as of January 1, 1984.) Moreover, our ability to comment on these rules is further hampered by the fact that the IRS has just issued very complex regulations implementing the "top heavy" statutory language. As a result, industry analysis of both the "top heavy" statutory provisions and accompanying regulations is still continuing. Given this situation, it would be fruitless to attempt at this time to analyze the rules in any detailed fashion before the Subcommittee.

Our problem in commenting on the effects of the TEFRA pension rules is exacerbated by the hasty manner in which these rules were enacted. The development of TEFRA was characterized by the unusual lack of opportunity given our business and other interested parties to review and comment on the pension provisions ultimately adopted. Some of these provisions were derived from H.R. 6410 (the "Pension Equity Act of 1982"), a bill which the industry was never given adequate time to thoroughly consider. H.R. 6410 was introduced in mid-May, with hearings held less than a month later. Although H.R. 6410 itself was not enacted in full, the final compromise evidenced in TEFRA was heavily influenced by the provisions of that measure.

Some of the TEFRA pension rules received even less public consideration than those derived from H.R. 6410. The "top heavy" rules, for example, were not part of H.R. 6410, but, rather, were products of a midnight Conference session. These "top heavy" rules were neither seen nor commented on by the insurance industry until the rules surfaced in the final TEFRA language.

In sum, the ACLI does not have adequate experience with the TEFRA pension rules to comment on their impact at this time. In view of this situation, the ACLI believes that another hearing should be scheduled for later next year. By that time the industry will have had sufficient time to provide the Subcommittee with the more detailed analysis that this subject merits.

We would like to add two final observations. The ACLI agrees that improvements in pension law are both necessary and appropriate. We are troubled, however, by the sheer quantity of changes that have been made in recent years. Every session of Congress witnesses another round of pension law revisions--revisions which necessitate burdensome amendments, at considerable cost, to existing pension plans. While one set of changes is burdensome enough, in the aggregate, the drain of continual, Congressionally-mandated alterations is enormous. We are seriously concerned that this process is having a significant adverse impact on the private pension community.

We are also troubled by the lack of orderly process that characterized the development of TEFRA's pension provisions. Noticeably absent from that process was any substantive opportunity for the life insurance industry and other interested parties to present their views on provisions as they evolved. Moreover, even Congress, in our view, had inadequate time to review the major pension changes contained in

TEFRA. We trust that this situation will not be repeated in the future and that the industry will be allowed a greater degree of participation in developing rules in this important area.

The ACLI strongly believes that public policy should be developed that will encourage personal retirement savings. Employer-sponsored pension plans provide essential financial protection and security to many millions of individuals. Pension plans also perform the extremely important function of facilitating capital formation so necessary for a dynamic economy, higher income levels and expanding employment.

At the end of 1981, for example, the investments backing up private pensions amounted to $472 billion, with those administered by life insurance companies alone approaching $193 billion. These funds are at work in our economy helping to create jobs and improved levels of living. They help build and modernize plants, schools and hospitals. They provide places for people to live, work, shop and play. They help stabilize our economy. In addition, the money invested by the life insurance business helps to provide guaranteed financial protection for millions of retirees and their families.

Retirement savings are an efficient allocation of national resources because they are drawn from the very broad base of personal income and then are directed to productive uses through diversified investments. The resulting accumulation of investment funds is put to work immediately to serve capital needs throughout the entire economy. The expansion of this inherently desirable form of savings should be fostered rather than impeded.

We appreciate having the opportunity to present our views on this very important subject. We would be happy to answer any questions the Subcommittee might have and to furnish any additional information the Subcommittee might desire.

STATEMENT OF
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

PRESENTED TO THE

FINANCE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT

APRIL 25, 1983

ON THE TOPIC OF

PENSION PROVISIONS IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

AGC is:

- More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
- 112 chapters nationwide;
- More than 80% of America's contract construction of of commercial buildings, highways, industrial and municipal-utility facilities;
- Over $100 billion of construction volume annually.

The Associated General Contractors of America (AGC) represents more than 32,000 firms including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,400,000 employees. These member contractors perform more than 80% of America's contract construction of buildings, highways, bridges, tunnels, dams, waste-water treatment facilities, transmission lines, refineries, among many other industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the Pension provisions in the Tax Equity and Fiscal Responsibility Act of 1982.

TEFRA's pension provisions will have a negative impact on the private retirement system in the United States and the negative effects of the Act can be expected to grow in future years. Reduced contribution limits, suspension of indexing contribution limits, imposition of restrictive and arbitrary "top heavy" plan rules, drastic limits on the estate tax exclusion, and a variety of other provisions in TEFRA have made the creation and continuation of private pension and profit sharing plans much less attractive. These negative policies should be reversed.

The following are specific criticisms of the TEFRA provisions we have identified:

Limitations on Contributions to and Benefits Under Qualified Plans. The original contribution levels in the Employee Retirement Income Security Act of 1974 (ERISA) established maximum contribution levels which were deemed to provide an adequate base. These base amounts were indexed to the primary insurance rates as the appropriate cost-of-living index for private retirement programs. The benefit levels established by ERISA in 1974 with their appropriate adjustments based on the primary insurance index should be restored.

The lower maximum contribution limits impact severely on cylical industries like construction. In industries like construction, which have traditional cycles of prosperity and decline, firms cannot always make contributions to plans at funding levels established by the firm because of insufficient funds. This situation arises typically under profit sharing plans when an employer chooses to contribute more during some years than others. The lower maximum contribution limits hinder the firm's ability to maintain the benefit level it believes is appropriate by restricting higher contribution amounts in prosperous years to make up for poorer years.

The reduction in the maximum contribution limit of 1.4 to 1.25 for multiple plans has the same negative impact as the other restrictions on contribution levels. Limiting the use of different plans by limiting the benefit levels undercuts the private retirement system which has had a superior economic performance when compared to public retirement programs. Restrictions on multiple plans limits the economic security of American workers who would otherwise be entitled to a more comfortable retirement after decades of work.

Retirement Age. TEFRA's requirement that actuarial benefit reductions be made if an employee retires before age 62 rather than age 65 is an unappropriate interference with private retirement decisions. Private retirement programs are developed for a variety of reasons and can be structured by an employer to meet the needs of both the employer and employee. If an employer wishes to provide for earlier retirement benefits it is not sound public policy for the government to make it more difficult for individuals to retire by reducing their benefits. While the public retirement system may require an increased retirement age due to excessive benefit levels established by the social security system there is no sound policy for restricting benefits actually earned and paid for by employees and their employers. AGC urges that actuarial reductions in benefit levels for early retirement be restored to their pre-ERTA levels.

"Top-heavy" plans. The new rules designating certain plans to be "top-heavy" create a substantial administrative burden to an already complicated area of the tax law and should be repealed. This burden is especially cumbersome for the construction industry which is characterized by small highly competitive firms. The present rules based on the designation of officers, equity holders, and compensation levels provide numerous technical traps for firms to deal with. Due to the severity of the penalties (plan disqualification) for failing to comply with these complicated rules a taxpayer must go to substantial expense to maintain a plan. The numerous restrictions on plan administration which follow the top heavy classification will also create a significant administrative problem and expense.

Limitation on estate tax exclusion. The $100,000 aggregate limit on the estate tax for certain retirement benefits payable under qualified plans and other retirement benefit vehicles is an unnecessary restriction which has no relationship to the policy of providing retirement benefits for American workers. Limitations on the estate tax exclusion in TEFRA makes the transfer of closely-held businesses more difficult and lessens the chances a firm can continue under family management following the death of a controlling principal. The TEFRA provisions on this subject should be repealed.

Limitations on Loans. TEFRA's limitations on loans made to plan participants needlessly hinder legitimate loans to plan participants without any benefit to the private retirement system. Prior to TEFRA a plan could generally loan funds to a participant if the loan bore a reasonable rate, was adequately secured, contained a reasonable repayment schedule, and the plan's loan program was administered on a nondiscriminating basis. The maximum limitations on loans to participants and related rules in TEFRA discourage loans and the general use of qualified pension plans. A legitimate obligation to repay the loan, as required under prior law, does not reduce plan assets and does not injure the private retirement system. Any abuses of loans by qualified plans related to income tax collection can be corrected by other means without affecting the vast majority of plans and their participants. AGC also urges the repeal of these provisions.

CARNACHAN, HENDRICKSON & ASSOCIATES
CONSULTANTS • ACTUARIES • EMPLOYEE RETIREMENT PLANS
ESTABLISHED 1960

[illegible] NORTH CENTRAL AVENUE, SUITE 10
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(213) 245-6566 (213) 244-9086

March 4, 1983

Senator Robert Dole
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Dole:

We have read that you are to hold hearings upon a Retirement Equity Act of 1983. Among the items being considered for inclusion in the proposed act are several concerning retirement plans.

As actuaries and consultants we are involved in the administration of about 180 pension and profit sharing plans. Based upon our experience we would like to make comments concerning the items reputed to be under consideration:

1. Dropping the required minimum age for the plan participation from 25 to 21 years of age.

   We are wholly in accord with this proposal. We have dissuaded most of our corporate clients from using any minimum age in their plans. The only valid argument in favor of a minimum age is to hold down the paperwork and administration expense involved with the rapid turnover in the younger ages. However, we believe this is more than offset by the fairness of being non-discriminatory with respect to all employees.

2. Requiring spousal consent before an employee can waive the joint and annuity form of retirement pension.

   California is a community property state. However, many non-community property states are also recognizing that a pension acquired during marriage is the joint property of both employee and spouse. Therefore, it is only right that the spouse have some say in how that pension is to be paid.

3. Requiring that the value of nonforfeitable pension benefits be payable to the employee's beneficiary at death before retirement.

   Of the 180 plans we work with, the vast majority are plans of small corporations, typically covering fewer than 25 employees. Without exception, the pension plans of those small corporations provide that the value of the total accrued pension, not simply the nonforfeitable pension, is payable as a death benefit. However, these small corporations usually do not have a group life insurance plan. If they do, it is typically a $5,000 to $10,000 rider on their group medical insurance.

In the few large plans we work with (covering 250 to 3,000 employees) there is no pre-retirement death benefit from the pension plan. However, in each case the employer maintains a separate group life insurance program. The death benefits from the group life insurance usually are from 1 to 3 times the employee's annual earnings.

We are opposed to requiring pre-retirement death benefits in pension plans. They do not address the survivor's needs as well as group life insurance. A 35 year old employee who dies leaving a widow and 3 minor children needs much more death benefit than the value of his nonforfeitable pension benefit. On the other hand, the large death benefit resulting from value of the total nonforfeitable pension accrued by an employee who dies at age 62 is more than really needed by a widow with no dependents.

If a death benefit equal to the value of nonforfeitable benefits is required in a defined benefit pension plan, it usually raises plan costs by over 15%. Unfortunately, mandating increased pension costs by legislation not only discourages the adoption of new plans but leads to the termination of existing plans. We found this out with ERISA, when approximately 30% of the plans we worked with were terminated by the employer sponsors.

We trust that you will give consideration to the comments made in this letter in drafting any bill concerning retirement plans.

Sincerely,

Cynthia B. Hendrickson

Cynthia B. Hendrickson
President

HEARING OF APRIL 11, 1983

COMMITTEE ON FINANCE
SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

REVIEW OF TEFRA LEGISLATION

This written testimony is offered regarding the possible unintended adverse consequences resulting from changes made in last year's TEFRA legislation to Section 401(a)(9) of the Internal Revenue Code.

Specifically, we are very concerned with wording contained in Section 401(a)(9)(B) as it may impact the payment of our survivor's annuity benefit to a dependent child. To illustrate, our plan provides for the payment of a survivor's annuity upon the death of an employee in service. While this annuity is normally payable to the surviving spouse and increased by a specified amount for each minor child under the age of 18, the benefit can be paid to a child or children alone if a qualifying surviving spouse does not exist. This situation occurs with some degree of frequency due to the fact that our plan requires that the marriage to the employee must have been in existence at least one year prior to the employee's death. Thus, due to the occurrence of a divorce or a common catastrophe where the employee and spouse are killed at the same time, survivor benefits are often paid to minor children.

In reviewing Section 401(a)(9)(B), it is noted that where benefits are paid to other than the employee or his surviving spouse, the distribution must be made within five years after the death of the employee or the surviving spouse. Recognizing that our survivor benefit program provides for the payment of benefits to minor children until attainment of age 18, this provision could result in either the loss of benefits to minor children who were younger than age 13 at date of death of the employee or require amendment of our plan to *distribute the value* of these benefits over a period not to exceed five years.

While it appears that the changes made to Section 401(a)(9) were primarily intended to resolve abuses in the estate tax area, I feel certain that the situation I have outlined whereby minor children and orphans may be denied benefits was unintended. While the comments I have made pertain specifically to the impact of changes made to Section 401(a)(9)(B) to the specific program I administer, I can assure you from my involvement as an officer of the National Association of State Retirement Administrators and chairman of the Committee on Public Employee Retirement Administration of MFOA, that the problem has universal application to public employee pension plans throughout the country. If I may provide any additional information which will allow you or members of the Subcommittee to better understand this problem, please let me know.

Michael L. Mory

Michael L. Mory, Executive Secretary
State Employees' Retirement System
of Illinois

LEVER, ANKER & ASSOCIATES
CERTIFIED PUBLIC ACCOUNTANTS
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ERNEST M. LEVER
KURT R. ANKER

273-2145
272-0475

May 5, 1983

Roderick A. DeArment,
Chief Counsel
Committee on Finance
Room SD-221
Dirksen Senate Office Building
Washington, D. C. 20510

Re: [redacted]

Gentlemen:

I urge that pension plan laws set forth in the Internal Revenue Code be amended to protect the rights of women employees who leave the work force to bear children (S 19 (2)).

The pension plan laws should make accrued benefits of spouses subject to the jurisdiction of state courts in the event of a marital dissolution. (S 19 (4)). Such a change would automatically protect the rights of a surviving spouse to the benefits granted to such spouse in the event that death should intervene in the dissolution process. (S 19 (5)).

I do not favor lowering the age for participation purposes from 25 years to 21 years as employees in that age group have a large turnover and should be motivated to enhance their careers rather than be shackled to a relatively minor future pension benefit. (S 19 (1)).

The Internal Revenue Code should leave the freedom of choice to the plan participants and not increase requirements. (S 19 -(3)).

The main reason for this letter is to urge the Committee to substantially increase the deductible contributions to individual retirement accounts for working taxpayers. The present Social Security System is not set up or in a financial position to meet the retirement needs of the vast majority of the taxpayers. The need is urgent for taxpayers to build their own retirement program with the greatest amount of leeway possible. The contribution formula should be based upon a percentage of earned income. In turn, this percentage should increase as the taxpayer increases in age. This suggestion would stimulate savings, increase social stability and foster a concern for the future welfare of the taxpayer and thereby of this country.

Sincerely yours,

KURT R. ANKER

MUNICIPAL FINANCE
OFFICERS ASSOCIATION

[illegible]

April 11, 1983

The Honorable John M. Chafee
Chairman of the Subcommittee on Savings,
Pensions, and Investment Policy of the
Committee on Finance
SD-221 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

The Committee on Public Employee Retirement Administration (COPERA), a policy-writing committee of the Municipal Finance Officers Association comprised of public pension administrators, is concerned with the unintended consequence Section 401(a)(9) (B) of the Internal Revenue Code will have on the distribution of survivor benefits to minor children.

This section, amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) to curb estate tax abuses through non-spouse benefit payments, carries repercussions for qualified public pension plans and their benefit recipients. This new provision requires that upon the death of the plan participant, if the beneficiary is someone other than a spouse, the entire value of the annuity must be paid out within a five year period.

Many state and local pension plans provide for the payment of a beneficiary annuity to a child or children until the age of 18. In the case of an orphaned child or a child of divorced parents, a strict interpretation of the language in Section 401(a)(9)(B) would require all benefits to be paid out within five years. Therefore, an infant would be paid the full value of the annuity by the age of six.* Clearly, this was not the intent of this legislation.

Annuity payments to minor beneficiaries are not considered part of the deceased parents estate. The probate court has no jurisdiction over such payments leaving full discretion of their use to the guardian.

The COPERA strongly urges the Congress and the Administration to review the matter and to make the necessary adjustments in the Code during the consideration of a technical corrections bill to the TEFRA.

BEST COPY AVAILABLE

The Municipal Finance Officers Association represents 9,000 members who are state and local government finance officials, appointive and elective, and public finance and pension specialists. If we can be of assistance on this or any other issue, please contact Cathie Eitelberg at 466-2014.

Sincerely,

Catherine L. Spain

Catherine L. Spain
Director
Federal Liaison Center

STATEMENT

OF THE

NATIONAL AUTOMOBILE DEALERS ASSOCIATION

TO THE

SENATE FINANCE SUBCOMMITTEE

ON

SAVINGS, PENSIONS, AND INVESTMENT POLICY

ON

THE EFFECT ON PRIVATE PENSION PLANS OF PENSION PROVISIONS IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

April 11, 1983
Washington, D.C.

Submitted April 22, 1983

The National Automobile Dealers and Associates Retirement Trust (NADART) is part of the National Automobile Dealers Association (NADA), a trade association representing approximately 18,500 retail automobile dealers throughout the United States. NADART is the plan administrator of four Master Plans approved by the Internal Revenue Service. Members of the NADA may adopt one or more of the master plans sponsored by NADART. Currently, NADART administers approximately 5,000 small employer plans, covering approximately 70,000 employee participants and $550 million in assets.

The intent of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 is to prevent excess accumulations of tax-deferred funds by high income individuals, to reduce incentives to use pension plans as a method of sheltering income from tax, and create parity between corporate and noncorporate pension plans. Senator Chaffee noted "..while TEFRA addressed abuses in pension law and overly generous tax incentives, great care was taken in an attempt to insure that the changes in TEFRA will not jeopardize our private pension system."

It is our belief that the provisions of TEFRA will indeed jeopardize our private pension system, and more specifically, will have a negative impact on our small employer plans resulting in increased plan terminations. The top heavy regulations as proposed would adversely effect small businesses such as the dealers participating in the NADART plans, by significantly increasing the cost of maintaining qualified retirement plans, providing an incentive for dealers to terminate their existing plans due to minimum contribution requirements for employees who decline participation in contributory plans and unnecessarily rapid vesting schedules, and destroying any incentive to establish new plans.

We feel that the Internal Revenue's proposed top heavy regulations are inappropriate at a time when small businesses should be encouraged to set up retirement plans to ease the burden on a troubled Social Security system. The adverse effect of the top heavy provisions on small businesses, such as the NADART plans, will provide an impetus for some of our participating employers to terminate their plans and damage the long term capital pool at a time when participation in pension plans on the part of the employer and the employee should be encouraged.

As I am sure that you are aware, economic conditions have not been the best for automobile dealers; due to unfavorable economic conditions, many of our dealers were forced to terminate their retirement plans within the past few years. The new restrictions created by TEFRA may provide further reason for our plan sponsors to terminate existing plans or never initiate plans in the first place.

One of the minimum contribution requirements of the provisions of TEFRA which we feel would have the most serious impact on an automobile dealer's plan with NADART would be THE MINIMUM CONTRIBUTION REQUIREMENT for employees who have declined to make mandatory contributions. The majority, approximately 80% of our plans, are contributory money purchase pension plans, typically providing for an employee mandatory contribution with a matching employer contribution. The philosophy of our dealers is quite simply that retirement plans should be a long term committment by BOTH employer AND employee. The dealers participating in our plans are eager to help those employees who have an interest in helping themselves provide for retirement savings by matching the employee's contribution. Our typical participating dealer is not intent on helping an employee who has no interest in his future retirement, and who has in the past jeopardized the qualified status of a dealers pension plan by declining participation.

In a contributory plan, if this minimum contribution must be provided for all employees whether or not they make mandatory contributions, the only choice for the employer would be to eliminate the mandatory contribution entirely. This would result in total contradiction of our dealers philosophy that it is crucial to the development of a healthy private pension plan that small employers share the cost of providing meaningful retirement benefits with their employees; this would also result in some of our dealers terminating their retirement plans. In the end, a minimum contribution requirement that was intended to help the rank-and-file employees, could easily result in termination of the plan and the loss of benefits to all employees.

Due to the nature of the retail automobile business, imposition of unnecessarily ACCELERATED VESTING SCHEDULES imposes a hardship on such small businesses because of high turnover. Accelerated vesting removes a useful tool for retaining good employees. Too rapid vesting schedules defeat the purpose of retirement plans - retirement plans should do just that - provide retirement savings - not provide for relatively current compensation after three to six years. We feel that the existing ten year vesting schedule should be sufficient.

We feel that both the ADMINISTRATIVE AND MONETARY BURDENS of TEFRA will primarily affect small businesses such as our dealer sponsored plans. It would appear that large businesses would hardly ever have to be concerned with administering top heavy rules since, by definition, the proposed rules limiting the number of individuals who could even be key employees under the officer classification make it mathematically impossible for a large corporation to be top heavy. On the other hand, a plan administrator such as NADART must collect detailed information from our plan sponsors, and perform complicated analyses to determine "key employees." The five-year period for which this detailed information must be collected even further adds to this administrative nightmare.

The five-year look-back rule where distributions must be added to current account balances is impossible to administer since most file data bases retain no more than two years of current records. Any required calculations to include distributions paid in the 1980-1983 plan years will have to be done on a manual basis; this can prove extremely costly to plan administrators. We would suggest minimizing this administrative nightmare by gradually phasing in the five-year distribution requirement so that a plan administrators computer file can be reprogrammed to accomodate storage of distribution data for five plan years. Plan administrators are just not equipped to pick up distributions back to the 1980 plan year without incurring outrageous costs.

Another administrative factor which concerns NADART is the considerable costs involved in amending our 5,000 plans and submitting the same to IRS. The combination of this expense, coupled with the minimum contributions and rapid vesting noted above, will undoubtedly trigger plan terminations.

We feel that the provisions of TEFRA providing parity in the elimination of distributions between corporate retirement plans and KEOGH plans for self-employed individuals and their employees were necessary, but we do not understand the LACK OF PARITY THAT NOW EXISTS BETWEEN THE LARGE AND SMALL EMPLOYER by making administrative restrictions so burdensome for the small employer that he is discouraged from setting up small private pension plans. Since small businesses are much more likely to be top heavy and thus subject to the top heavy restrictions, why should the owners or key employees of a small business be treated any differently than a key employee of a large corporation by having a 10% additional tax imposed on a distribution to a key employee for withdrawals prior to age 59 1/2?

While we do agree with the intent of Congress in that the provisions of TEFRA should assure equitable benefits and/or contributions for the rank-and-file employees, we feel that unrealistic, complex restrictions placed on the small employers will cause plan terminations, in the end providing no benefits for the rank-and-file. The owners of small corporations would be likely to set up an Individual Retirement Account for themselves and probably some type of non-qualified deferred compensation plan for themselves and their key employees, but the rank-and-file employees would most likely continue to depend primarily on our Social Security system to provide retirement benefits.

We appreciate the opportunity to present our concerns as to the effects of the TEFRA provisions on our small employer plans, and hope that consideration will be given to modification of those provisions that will discourage small employers from terminating their plans - plans which are an essential part of the private pension system providing the single most reliable mechanism for the long term growth of retirement savings.

Thank you.

Respectfully Submitted

NATIONAL AUTOMOBILE DEALERS
AND ASSOCIATES RETIREMENT TRUST

By: Barbara Collins
Compliance Department

STATEMENT OF WILLIAM J. FLYNN,
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
NATIONAL HEALTH AND WELFARE MUTUAL LIFE INSURANCE ASSOCIATION
BEFORE THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT POLICY OF THE SENATE COMMITTEE ON FINANCE ON THE EFFECT ON PRIVATE PENSION PLANS OF PENSION PROVISIONS IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (TEFRA)

April 11, 1983

Mr. Chairman and Members of the Committee:

My name is William J. Flynn. I am Chairman and Chief Executive Officer of the National Health and Welfare Mutual Life Insurance Association ("NHW"). NHW is a tax-exempt, non-profit organization as described under Section 501(c)(4) of the Code, and limited by its charter to underwriting employee benefit plans for non-profit health and welfare agencies. Presently, NHW insures and administers pension plans for approximately 3,500 such agencies. NHW was founded in 1945 by leaders of a number of these non-profit health and welfare organizations. Its board includes many officials of charitable agencies in the health and welfare field, including the United Way, the Girl Scouts of America and others. It is indeed a privilege to make a presentation to you on the effect that changes in the tax law enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") may have on pension plans maintained by our non-profit policyholders.

We are most concerned with the new provisions on top-heavy plans enacted into law by Section 240 of TEFRA. The top-heavy rules found in new Section 416 of the Internal Revenue Code impose new standards on private pension plans that are weighted in favor of owners and highly compensated officers of a business corporation. The new top-heavy rules basically reduce the amount that can be contributed for these owners and employees annually, and provide minimum pension benefits for other, rank-and-file company employees. An unintended result of the Section 416 top-heavy rules as currently interpreted is that they appear to cover pension plans maintained by publicly supported non-profit as well as business corporations. This will result in such non-profit corporations bearing increased administrative costs and paying higher premiums to fund costly new TEFRA-imposed employee benefits. We do not believe that this was intended by Congress. We sincerely hope that this uncertainty in the law can be resolved expeditiously by either administrative or legislative means, so that NHW policyholders will not be faced with the needless burden of compliance with Section 240 of TEFRA.

Since this is the first time that NHW has testified before the Congress and this Committee on TEFRA's top-heavy rules, I thought that I would begin by describing the types of pension plans that are maintained by our policyholders and insured by NHW. Pension plans of organizations that belong to NHW include both defined benefit and defined contribution plans. Many of these plans are tax-qualified under Code Section 401(a). Although qualification is of no tax value to the tax-exempt plan sponsors, a determination that a plan is non-discriminatory is consistent with the spirit of publicly supported non-profit, service organizations that our policyholders embody. It also removes any ambiguity over the covered employees' right to treat such pension benefits as non-taxable until the pension benefits are received upon retirement. By and large our policyholders' pension plans are small with 20 or fewer participants. NHW-insured pension plans are maintained by such charitable organizations as United Ways, and local social service and health agencies.

While apparently unintentional, TEFRA's top-heavy rules for private pension plans, under current IRS interpretation, will be applied to tax-qualified non-profit organization pension plans insured by NHW. Unless changed, this will require our policyholders to include top-heavy provisions in their plans, make annual calculations to determine top-heaviness, and fund costly new benefits. Let me explain the reasons for our concern.

Under Code Section 416, a pension plan is considered top-heavy when 60 percent or more of the present value of accrued benefits under the plan are going to the company's owners and highly paid officers. The latter are referred to under new Section 416(i)(1) as "key employees," defined to include major shareholders of a company, employees with minimal stock ownership earning over $150,000 annually, and "officers" of the company (limited under no circumstances to more than 50 employees). If a plan meets the "key employee" test, that is, if 60 percent of the plan's accrued benefits are going to such key employees, then it is considered top-heavy and must comply with the tougher vesting and minimum benefit standards, and the limitations on benefits and distributions for key employees.

I should point out that even if a plan is not found to be top-heavy, the requirement that the plan contain top-heavy provisions and make an annual determination of top-heaviness applies to all tax-qualified pension plans. Our policyholders will be subject to these burdensome requirements unless exempted altogether from TEFRA's top-heavy provisions.

What we find a great cause for alarm is that many plans of publicly supported non-profit organizations that are tax-qualified will be found to be "top-heavy" under Section 416's definition. For these charitable organizations this will increase pension costs needlessly without curing any perceived abuse in these plans.

The owner/highly compensated employee test for "key employees" is aimed at profit-making corporations. However, because of the "officer" component of the "key employee" test, publicly supported non-profit organizations with tax-qualified pension plans are snarled in its web. NHW-insured charitable organizations have paid "officers" with titles such as president, executive director, executive secretary and administrator. Many other officers are volunteers. Because of the small size of these charitable health and welfare organizations, the presence of one or two paid "officers" will trigger application of the special rules for top-heavy plans.

NHW analyzed a random sample of 98 defined benefit pension plans maintained by our policyholders. Typically these plans have benefit formulas of (i) 1% of final average salary times years of credited service, plus (ii) 1% of salary in excess of the Social Security average annual wage (currently $11,004) times years of credited service up to thirty years. The benefit is normally fully vested after five years or less of credited service.

In spite of the patently nondiscriminatory nature of these plans, the study shows that almost 30 percent (28 of 98) would be subject to the more stringent, top-heavy standards. Two-thirds of these plans (65 of 98) have 20 or fewer participants. Forty-one and one-half percent (41-1/2%) of these plans with 20 or fewer employees are "top-heavy." In most cases, the "one key employee" situation will most likely hold and trigger a "top-heavy" finding for smaller plans. Chart 1 attached to my statement depicts this analysis.

It may be argued that pension plans of non-profit organizations should be treated the same as other tax-qualified pension plans when in excess of 60 percent of accrued benefits are going to a few so-called "key employees." However, the non-profit pension plans that NHW administers--and our policyholders sponsor--are in most cases tax-qualified and do meet Section 401(a)(4)'s prohibition against discrimination in favor of officers, directors and highly-compensated employees. Nevertheless there are unique circumstances that cause many pension plans offered by non-profit charitable organizations to be "top-heavy." At the same time, there is nothing unfair about the manner in which non-profit public charities are organizing their pension plans and there are no abuses resulting from the operation of publicly supported plans that warrant imposition of the top-heavy rules on these organizations' pension plans.

The key circumstances triggering application of the top-heavy rules to these plans are their small size and work force salary distribution.

- Eighty-eight of the 98 defined benefit plans we surveyed have less than 50 participants; two-thirds have 20 or fewer participants (see Chart 1).
- In these small plans, the key employees, the charitable organization's paid officers, are not highly compensated. This salary information is summarized in Chart 2 attached to my statement. For plans with 11 to 20 participants, for example, the average "highest" salary was $31,700. Few officers had salaries as high as $60,000; some earned as little as $19,300. What gives rise to our problem is the disparity between those one or two individuals with modest, but relatively high salaries (for these organizations), and the average employee salary of approximately $15,300 for this group of non-profits. As is obvious, charitable organizations are not in a position to be very "generous" with their employees. In fact, the highest-paid employee in 93 percent (92 of 98) of the surveyed plans earned $60,000 or less (see Chart 2).
- These plans are small, in part, because charitable agencies rely heavily on volunteers for much of their charitable activities. These volunteers are unpaid, are not counted as employees and do not participate in the pension plan. Nevertheless, their activity accounts for a great deal of the organization's workload; the responsibilities of the few officers of the charitable

organization include supervision of these volunteer efforts. The "key employee" test for determining top-heaviness cannot take account of these unique factors.

- Finally, top employees of public charities are likely to have considerable years of service in health and welfare agencies. The pension plans maintained by NHW-insured organizations often reinforce that consideration with desirable features available to all employees of the organization such as portability and early vesting.

It is the NHW-insured defined benefit plans maintained by the health and welfare organizations that are most succeptible to coverage under the top-heavy rules. We found that few of our policyholders maintaining defined contribution plans would be considered to be "top heavy." It appears that the combination of a relatively high final average salary coupled with many years of service for a few key officers under our defined benefit plans, while others in the small organization earn modest salaries, results in a high percentage of "top-heaviness" among our defined benefit plans.

NHW has concluded that compliance with TEFRA's top-heavy rules will be very expensive for the non-profit organizations that sponsor these plans. The added burdens are three-fold.

1. Minimum Benefit Cost. For many of the defined benefit plans that would be found to be "top-heavy," funding of the required minimum benefit would average 10 to 15 percent of present cost and may run as high as 100 percent in some cases. The minimum benefit under TEFRA for a defined benefit plan that is "top heavy" requires that the employee accrue each year a retirement

benefit not less than two percent of his average compensation multiplied by his years of service, up to 20 percent of average compensation. In other words, a non-key employee must accrue 1/5 of his retirement benefit over the first ten years of service at 2 percent annually. By contrast, we expect little additional cost for those defined contribution plans that are subject to the top-heavy rules. Almost all of the NHW-insured plans already meet the required minimum benefit of three percent of contribution applicable to "top-heavy" defined contribution plans.

2. Administrative Expense. The annual administrative burden of determining whether or not a plan is top-heavy will be significant for all non-profit plan sponsors. Application of the top-heavy rules to public charity non-profit organizations will require NHW to rewrite a major portion of its computer program used to determine the amount of accrued benefits in retirement accounts for individual participants; and to determine the plan sponsor's minimum funding level for the year. This will be necessary to administer the key employee determination rules that are based on cumulative accrued benefits and aggregate account balances. These are costs that ultimately will be borne by all plan sponsors in terms of higher administrative expenses.

3. Key Employee Distributions. There will also be a large burden on those officers who are determined to be key employees if the plan is top-heavy. If such a key employee of a public charity non-profit retires before age 59-1/2 and opts to receive

his pension at that time, TEFRA imposes a 10 percent tax penalty on him. (Also, key employees have to begin to receive distributions by age 70-1/2.) Increasing the burden on the officers of a public charity non-profit will only make it more difficult for charitable non-profit organizations to attract the kind of top-notch administrators that we need to run these public service organizations. Since salaries are already modest, placing additional burdens on such employees in terms of access to their retirement benefits can only make a tough job even tougher.

The problems posed for publicly supported non-profit organizations could be avoided by exclusion of our "officers" from the "key employee" definition for determining top heaviness. NHW does not believe that paid officers of such organizations necessarily must be treated as "key employees" for purposes of applying the top-heavy rules. State and local governments also have officers--both elected and appointed. Yet the IRS proposed regulations implementing the top-heavy provisions of TEFRA, issued March 15, 1983, 48 F.R. 10868, state that "no employee of the state is or could be a key employee . . ." as that term is used in Section 416(i)(1) for top-heavy plans. As a result, state government employee retirement plans need not include top-heavy provisions. [Id., T-28, Q and A.] The IRS proposed regulations do not contain a similar interpretation for officers of publicly supported non-profit organizations that would allow their pension plans to avoid compliance with the top-heavy provisions.

The characteristics of non-profit corporate officers employed by not-for-profit organizations that are publicly supported, argue forcefully for such an interpretation. Officers of a publicly supported non-profit organization much more closely resemble state and local government officers than officers of a private, for-profit corporation.

-- First, unlike private corporations, the chief executive officer of a public charity non-profit is often not a member of the board or is a member ex officio without a vote.

-- Second, public charity board members are volunteers drawn widely from the community to serve for fixed terms with limited succession. Contrasted with business corporations, paid officers of public charity non-profits do not control selection of board members or their successors.

-- Third, volunteer boards determine in fact and law salary of executives and salary ranges and benefits for all employees. In this respect, the voluntary board of a public charity serves a function analogous to that of the state legislature in determining salaries and benefits for officers and other employees.

There appears to be little basis for treating "officers" of non-profit public charities differently from those of state government, and subjecting pension plans of these non-profit charitable organizations to TEFRA's top-heavy provisions.

What then should be done? It is clear to NHW that Congress did not intend the top-heavy rules to cover pension plans maintained by non-profit charitable organizations. The evil the TEFRA sought to correct was in the private sector: pension plans that unduly favored the owners and highly-compensated officials of profit-making companies at the expense of rank-and-file employees. These owners and highly paid corporate officers could amass for themselves a large pension based on before-tax dollars deducted as a business expense by the companies they controlled.

The new Section 415 dollar limitation on annual benefits payable under a defined benefit plan of $90,000 for any one employee (reduced from $136,425 annually) may be relevant to private employers. For public charity non-profits it's a limitation that not one employee or officer of these organizations will come even close to receiving.

The requested relief from the top-heavy rules can legitimately be limited to publicly supported, non-profit organizations. These are organizations described in Section 170(b)(1)(A)(vi) of the Code which normally receive a substantial part of their support "from a governmental unit or from direct or indirect contributions from the general public . . ." (emphasis supplied). Under Reg. Section 1.170A-9(e) an organization is considered to have a "substantial part of its support" from the public if its government and general public support equal at least 33-1/3 percent of its total support or if it has a minimum of 10 percent public support and meets other tests as to its public nature such as a broadly based public board. United Ways and health and welfare agencies maintaining pension plan administered by NHW are typical of such publicly supported organizations. A narrow exemption from the top-heavy rules for publicly supported non-profit organizations is consistent with the intent of Congress, narrowly focused and easily administered.

The IRS' proposed top-heavy regulations appear to support NHW's conclusions as to Congress' intent in enacting these new rules. It was not your intent to subject non-profit organizations to the top-heavy provisions. One Q and A, T-11, in the proposed regulations reads: "For purposes of Section 416, do business organizations other than corporations have officers? [Answer] No" (emphasis added). 48 F.R. 10868, 10871. It is clear to me that the IRS, too, did not fully consider that the new top-heavy rules would be applied to not-for-profit charitable organizations with inequitable and unforseen results!

NHW respectfully submits that public charities, that is, publicly supported non-profit, tax-exempt charitable organizations, should be exempted from TEFRA's top-heavy rules. This is the same treatment accorded by the IRS under its proposed regulations to state and local government pension plans. (Technically, both classes of plans would be exempt from having to include top-heavy provisions in their pension plans as required by Sections 416(a) and 401(a)(10)(B).) As noted already in my statement, public charity non-profits as well as state and local governments should be exempt because they do not have officers as key employees in the same sense that for-profit corporations do. While both have officers, the officers' roles are limited in terms of policymaking and the determination of their own compensation. For both public charities and local governments, these important decisions are made by broad-based governing bodies that also set the rules for the officers' retirement plans. Local government and public charity non-profits have in common public purposes, public organization, public support and public operations.

NHW believes that the relief it seeks--exemption of public charity non-profit organizations from the top-heavy rules--can be achieved in one of two ways.

First, there is the administrative route. The IRS can issue in a further clarification of its March 15 proposed regulations, or in response to a private ruling request, a determination that publicly supported non-profit organizations (as described in Code Section 170(b)(1)(A)(vi)) are not subject to top-heavy rules because they do not have key employees within the meaning of Section 416(i)(1). Under Section 401(a)(10)(B) IRS is authorized to exempt certain plans by regulation from including top-heavy provisions in their plan documents. The effect of such administrative action would of course be to relieve publicly supported non-profits from the onerous obligation of compliance with the top-heavy rules.

Second, if IRS is reluctant to act in a timely fashion, we would urge Congress to amend Section 416 of the Code to exempt publicly supported non-profits from the top-heavy rules. This could take the form of a technical amendment to Section 416(i)(1) such that officers of Section 501(c)(3) not-for-profit charitable corporations that are publicly supported under Section 170(b)(1)(A)(vi) are not to be considered as officers for purposes of determining whether these corporations have "key employees" under this section. Such an amendment would restore our understanding of Congress' intent in enacting Section 240 of TEFRA--an intent to limit these top-heavy rules to pension plans of business corporations.

In conclusion, let me emphasize the need for prompt action by either the IRS or the Congress. TEFRA's new top-heavy rules take effect for plan years beginning after 1983. Not-for-profit public charities should not have to undergo the burdensome and expensive process of complying with these rules in the coming months. Public charities with tax-qualified pension plans should be treated the same as state and local governments and exempted from the top-heavy rules by administrative action or technical amendment of TEFRA. Should the IRS not act promptly on our concerns, I urge the Subcommittee to include the statutory relief that NHW seeks on behalf of our policyholders in any bill containing technical corrections of TEFRA to be considered by Congress this session.

Chart 1

NHW SURVEY OF DEFINED BENEFIT PENSION PLANS OF MEMBER NON-PROFIT ORGANIZATIONS

DISTRIBUTION OF TOP HEAVY PLANS BY NUMBER OF PARTICIPANTS

Number of Participants	Number of Plans	One Key Employee		10% Rule **	
		Number Top Heavy	Percentage Top Heavy	Number Top Heavy	Percentage Top Heavy
3 or less	17	15	88%	17	100%
4 through 6	17	4	24	14	82
7 through 10	15	6	40	8	53
11 through 20	16	2	13	8	50
21 through 50	23	1	4	3	13
over 50	10	0	0	2	20
Total	98	28	29%	52	53%

** Minimum 3 officers, maximum 50 officers.

Chart 2

NHW SURVEY OF DEFINED BENEFIT PENSION PLANS OF MEMBER NON-PROFIT ORGANIZATIONS

1. SAMPLE SALARY DISTRIBUTION OF SURVEYED PLANS

Number of Participants	Number of Plans	Average Payroll*	Average Salary*	Average Highest Salary*	Range** Average Salary*	Range** Highest Salary*
3 or less	17	$ 32.4	$ 14.4	$ 20.0	$ 11.6-26.7	$ 19.0-30.5
4 through 6	17	77.3	15.0	25.6	8.8-25.5	10.4-40.7
7 through 10	15	143.2	17.3	34.6	9.3-20.6	12.1-49.4
11 through 20	16	210.3	15.3	31.7	7.3-22.3	19.3-60.0
21 through 50	23	487.1	15.2	37.7	10.0-21.7	18.4-78.9
over 50	10	4,624.3	14.5	56.1	10.7-21.5	15.7-105.0

2. DISTRIBUTION OF HIGHEST SALARY IN SURVEYED PLANS

	$0 - $10,000	$10,001- $20,000	$20,001- $30,000	$30,001- $40,000	$40,001- $50,000	$50,001- $60,000	$60,001- $70,000	$70,001- $80,000	$80,001- $90,000	$90,001- $100,000	$100,001- $110,000
No. of Plans	4	17	33	21	11	6	-0-	2	3	-0-	1

* All dollar amounts are in thousands.
** Excludes plans with one participant.

SUPPLEMENTAL STATEMENT OF THE SMALL BUSINESS COUNCIL OF AMERICA, INC.

Morton A. Harris, Esq.
Harry V. Lamon, Jr., Esq.
Randy L. New, Esq.

TO BE ADDED TO THE RECORD OF
THE HEARINGS ON THE EFFECT ON PRIVATE PENSION PLANS
OF THE PENSION PROVISIONS IN THE
TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

UNITED STATES SENATE, WASHINGTON, D.C.

April 11, 1983

STATEMENT OF SMALL BUSINESS COUNCIL OF AMERICA, INC.

I. Introduction. The Small Business Council of America, Inc., ("SBCA") which represents over 2,000 small businesses located in 49 states, recommends that Section 240(a) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") be repealed or, in the alternative, that the effective date be delayed for further economic impact studies by the General Accounting Office, the Treasury Department, and the Joint Committee on Taxation. As the Subcommittee is aware, Section 240 of TEFRA added Section 416 to the Internal Revenue Code ("Code"), effective for years beginning after December 31, 1983. Code Section 416(a) generally states that a trust is not a qualified trust entitled to the tax advantages provided by the Code if it is a part of a "top-heavy" plan, unless the plan meets certain requirements.

While SBCA strongly urges the repeal or delay of Code Section 416, we are aware that Chairman Chafee expressed some reluctance to pursue the question of the general discriminatory effects of the top-heavy plan rules in The Effect on Private Pension Plans of Pension Provisions in the Tax Equity and Fiscal Responsibility Act of 1982, Hearings before the Finance Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance, 98th Cong., 1st Sess. (April 11, 1983), hereinafter referred to as TEFRA Hearings. Therefore, this statement also will address certain specific criticisms of the top-heavy plan rules as they currently exist. At the very least, SBCA recommends that Congress substantially revise the top-heavy plan rules, and that Congress delay the implementation of the rules for a reasonable period of time to allow the appropriate agencies to study the economic impact of the rules.

II. Criticisms of the Top-Heavy Plan Concept.

A. In General. SBCA recommends the repeal of Code Section 416 for six important reasons: (1) the top-heavy plan rules represent the first time since the enactment of the Internal Revenue Code that the Code by its express terms openly has discriminated against small employers; (2) the top-heavy plan rules will result in a significant number of plan terminations which will impact adversely on a number of important public policy goals; (3) the top-heavy plan rules significantly increase the administrative cost of maintaining qualified plans of small employers; (4) the top-heavy plan rules encourage employee turnover in small businesses; (5) the top-heavy plan rules will cause small employers to engage in economically counterproductive behavior; and (6) the top-heavy rules encourage employers to explore employee benefits other than qualified deferred compensation plans. The fact that insufficient data has been developed to quantify accurately the six disadvantages listed above suggests, at the very least, that Congress should delay the implementation of the top-heavy rules until the economic impact of these rules can be determined.

B. The Top-Heavy Rules Represent Unjustified Discrimination Against Small Employers. The fact that discrimination against small employers is inherent in the top-heavy rules has been acknowledged by all experts in the pension area, including all of the witnesses who testified at the TEFRA Hearings.

However, these rules are unique additions to the Code in that they are the only major, nonelective provisions of the Code which discriminate between small and large corporations. The top-heavy rules starkly contrast with the Subchapter S rules which generally allow a "small business corporation" to elect to be treated as a partnership. I.R.C. § 1361(b)(1). The Subchapter S rules allow a corporation to obtain the advantage of partnership tax treatment if the owners of the corporation are willing to accept the disadvantages of partnership tax treatment and to absorb the other costs of the election imposed by the Code. See I.R.C. §§ 1362, 1366-68. The Subchapter S rules do not discriminate adversely against large corporations since Congress carefully balanced the advantages and disadvantages of electing Subchapter S treatment. In contrast, the top-heavy rules mandate that small business employers, merely because they are small, endure certain disadvantages of maintaining a qualified plan for their employees without any compensating advantages.

The creation of discrimination between small employer plans and large employer plans also contrasts sharply with TEFRA's goal of eliminating "artifical distinctions" and creating parity between corporate and noncorporate plans. Senate Finance Committee, Press Release No. 83-121 (March 19, 1983). The distinctions which Section 416 creates between large and small employers are as artifical as the former distinctions between corporate and noncorporate plans because large employers and small employers "use pension plans as a method of sheltering income" and allow "excess accumulations of tax-deferred funds by high income individuals," the elimination of both of these acts being goals of TEFRA. Id.

The discrimination against small business inherent in the top-heavy rules is completely unjustified. First, although the top-heavy rules are discussed in the "Revenue Provisions" section of the Conference Commitee report, the short-term revenue gains from all of the TEFRA pension provisions constitute less than 2% of the total revenue gain expected from TEFRA. Most of that gain is expected from the changes made in Section 415 of the Code and not from the top-heavy rules. TEFRA Hearings (Statement of the Association of Private Pension and Welfare Plans, Inc.).

Second, Congress lacks the empirical data to support the assumption that employees benefit less from retirement programs sponsored by small employers than from retirement programs sponsored by large employers. Indeed, according to information supplied to the Subcommittee at the TEFRA Hearings, the retirement plans of eight large oil-related companies only provide for ten-year, cliff-vesting -- hardly generous provisions to find in presumably "benevolent" large employer plans. TEFRA Hearings (Statement of the American Society of Pension Actuaries).

Third, this discriminatory treatment of small employers ignores the fact that the favorable tax treatment afforded to qualified plans by virtue of Section 401(a) of the Code is, in essence, Congress' way of purchasing retirement benefits for rank-and-file employees. Corporate and noncorporate decision-makers, in this case, small business owners, provide benefits for all employees in exchange for the right to defer taxes on their salaries, salaries which would otherwise be taxed at the higher marginal tax rates. Assuming that Congress acknowledges this "purchase" aspect of Code Section 401(a), penalizing a small employer because he takes full advantage of the terms of the purchase is unjustified. Therefore, the top-heavy rules represent unjustified discrimination against small employers and should be repealed or, at least, delayed for further study.

C. The Top-Heavy Rules Will Result in a Significant Number of Qualified Plan Terminations and a Significant Number of Employer Decisions Against Initiating New Qualified Plans, Both of Which Will Impact Adversely Upon Important Social

Goals. Terminations and "no-start" decisions are an economically mandated result of the top-heavy rules because, to the extent that the rules impose significant, additional opportunity costs on small business employers who adopt or maintain qualified retirement plans, those employers who viewed qualified plans as marginally cost/beneficial before TEFRA will terminate existing qualified plans or choose not to initiate new qualified plans after TEFRA.

In the small business context, the owner/employee will be reluctant to structure a retirement plan which provides, in the aggregate, larger benefits for rank-and-file employees than for management employees. As Stephen H. Paley, Esquire, noted in his statement at the TEFRA Hearings on behalf of SBCA, practically all of the plans having less than 25 participants (which constitute ninety percent of the total number of all qualified plans) are designed so that the plan benefits are geared to the top earners' compensation. Those top earners are typically the owner/employees who should be encouraged and not discouraged by tax incentives to provide qualified plans for their lower paid, rank-and-file employees.

Also, the five basic limitations imposed on top-heavy plans by Code Section 416 (compensation limits, vesting requirements, minimum benefits, limits on contributions and benefits, and limitations on distributions to participants) either minimize the advantages of a qualified plan to key employees or increase the costs, that is, the disadvantages, of providing benefits to nonkey employees. Many small business employers, who "shop" for those tax-sheltering mechanisms which have the lowest opportunity costs, will terminate an existing plan or refuse to adopt a new plan (i) to the extent that the limits on benefits to key employees are so restrictive as to make a qualified retirement plan less advantageous than other tax-sheltering alternatives, or (ii) to the extent that the minimum benefit required to be contributed on behalf of nonkey employees causes a plan to be so costly as to be inferior to other tax-sheltering alternatives. Mr. Gerald Facciani, President of the Cleveland-based Professional Plan Administrators, Inc., confirmed that this perception is held by small business owners in his comments appearing in the Christian Science Monitor of November 22, 1982:

> [i]f an owner has the choice of either increasing pension funding for rank-and-file workers by 30% or 40% or terminating the plan, he'll terminate. He has plenty of other tax shelter avenues which he can put his money into. He doesn't have to provide a plan.

Christian Science Monitor, November 1982, p. 135. The top-heavy rules provide an economic incentive to terminate or refuse to initiate new qualified plans in the small business sector.

Persuasive evidence suggests that the number of terminations and "no-start" decisions will be significant. The witnesses who testified at the TEFRA Hearings noted several examples of specific employers who were contemplating or who had decided to terminate or refuse to initiate a qualified retirement plan. E.g., TEFRA Hearings (Statement of the ERISA Industry Committee). In mathematical terms, thirty to forty percent of small plans may be terminated. TEFRA Hearings (Statement of Dr. Silvester J. Schieber, Research Director of the Employee Benefit Research Institute), citing, Grupper, "The Furor Over TEFRA," Institutional Investor (February 1983), pp. 71-80. Information supplied by the South Florida Employee Benefits Council lends credence to this estimate. Its members believe that 900 of the 1,700 plans sponsored by their clients will be terminated after TEFRA becomes fully effective, substantially reducing or eliminating the retirement benefits of 14,000 rank-and-file employees. TEFRA Hearings (Statement of Charles P. Sacher, Esq., Past President of the South Florida Employee Benefits Council).

The prediction that thirty to forty percent of small plans will be terminated is not an outrageous estimate when compared with the significant number of terminations which occurred after Congress adopted the Employee Retirement Income Security Act of 1974 ("ERISA"). A General Accounting Office report issued in 1979 estimated that 18% of the 471,000 pension plans of all types with fewer than 100 participants which existed in mid-1977 were terminated and that ERISA was a major factor in the decision to terminate approximately 41% of the plans. Government Accounting Office, Report to Congress: Effects of the Employee Retirement Income Security Act on Pension Plans with Fewer than

100 Participants 1 (1979). An analysis of determination letters issued by the Service during the relevant period reveals both a dramatic increase in plan terminations after the passage of ERISA through 1977 and a marked decline in the number of new plan qualifications in 1975 and 1976. TEFRA Hearings (Statement of Dr. Silvester J. Schieber, Research Director of EBRI at iii). As Mr. Paley noted in his statement on behalf of SBCA at the TEFRA Hearings, over one-third of all small pension plans in the private sector terminated in 1974 after ERISA. The conclusion that 30 to 40% of all small plans will be terminated as a result of TEFRA is definitely reasonable based on the special sensitivity of small plans to tax law changes, as documented by the ERISA experience, and because the top-heavy rules, unlike ERISA, are primarily aimed at, and overtly discriminatory towards, small employer plans.

Of course, SBCA is not claiming that all plans which are terminated or not started as a result of TEFRA will be terminated or not started because of the top-heavy rules. However, the correct question is not how many plans will be terminated or not adopted as a direct result of the top-heavy rules; rather, the question is how many plans which will be terminated or which will not be started as a result of TEFRA would be retained or started, as the case may be, without the top-heavy rules?

If significant numbers of qualified plans are terminated or if a significant number of small business employers decide not to adopt new qualified plans, several public policy goals will be impacted. First, to the extent that significant numbers of employees, whether key employees or nonkey employees, are deprived of private pension plan benefits after TEFRA, reliance on the already overburdened Social Security system will increase. The top-heavy rules, therefore, will exacerbate what the President's Commission on Pension Policy characterized as the "most serious problem facing our retirement system today," that is, "the lack of pension coverage among private sector workers . . . ." President's Commission on Pension Policy, Toward a National Retirement Income Policy (February 26, 1981). Elimination of small business qualified plans ironically will leave thousands of rank-and-file employees without significant non-social security retirement income, while merely forcing small business owners to find other, yet less socially advantageous, tax-sheltering alternatives.

Second, one perhaps unanticipated result of the top-heavy rules is that small employers will increase their reliance on nonqualified deferred compensation plans. As an example of this phenomenun, interest among tax practitioners is increasing in nonqualified alternatives to qualified plans. See Thirteenth Annual Employee Benefits Institute: Planning Practices After TEFRA, April 21-22, 1983, hereinafter 13tn Institute (at which one speaker will discuss "Benefit Equalization and Supplemental Retirement Plans: Undoing TEFRA's

Cutbacks"). Since qualification of a plan generally protects the interest of plan participants, the top-heavy rules are counterproductive to the extent that small business employers substitute nonqualified plans benefitting only their key employees for qualified plans benefitting key and nonkey employees.

Finally, if significant numbers of qualified plans are terminated or not adopted and funded nonqualified plans are not adopted as substitutes, then the amount of capital investment in the economy which is currently provided by retirement plan funds will be partially lost. This result occurs because reserves will not be retained in a funded plan which may be used for capital investment. Even if funded nonqualified plans are adopted for key employees, however, the reserves which would have been maintained and invested to provide benefits for nonkey employees will be lost to the economy.

The amount of lost capital may be enormous since qualified profit sharing plans alone currently hold over $75,000,000,000 in invested assets. TEFRA Hearings (Statement of Walter Holan, President, Profit Sharing Council of America). The South Florida Employee Benefits Council, who estimated that 900 of the 1,700 plans sponsored by its members' clients will be terminated after TEFRA, also estimated that, as a result of the terminations, annual contributions to these plans will be reduced by more than

$40,000,000, representing a large loss of capital formation dollars to the economy. TEFRA Hearings (Statement of Charles P. Sacher, Esq., Past President of the South Florida Employee Benefits Council).

Even admitting that the Council's prediction is based on the total impact of the TEFRA pension provisions and not solely on the impact of the top-heavy rules, the prospect for the loss of capital formation dollars as a result of plan terminations caused by the top-heavy rules is substantial. Obviously, the top-heavy rules will result in significant numbers of harmful plan terminations and "no-start" decisions focused in the small business sector where, compared with the large business sector, fewer employees already are covered by qualified plans.

D. The Top-Heavy Rules, in Conjunction With the Other TEFRA Pension Provisions, Will Cause Significant Administrative Costs to Small Employers Who Maintain Qualified Plans. All plans must include provisions which automatically take effect if the plan becomes a top-heavy plan and which meet the top-heavy plan requirements. I.R.C. § 401(a)(10)(B)(ii); TEFRA § 240(b). Thus, each retirement plan must be amended even if the employer intends to prevent top-heavy status from occurring by permissive aggregation of plans, causing key employees to waive coverage under the plans, or otherwise.

Moreover, the recordkeeping requirements imposed upon employers have been increased significantly since a "key employee" includes any participant who in any time during the plan year or the last four plan years was: an officer, one of the ten employees who owns the largest interest in the employer, a five percent owner of the employer, or a one percent owner of the employer who earned annually more than $150,000 from the employer. I.R.C. § 416(i)(1)(A).

B. The Code Section 416 Rules Will Encourage Rapid Employee Turnover. A top-heavy plan must vest accrued benefits derived from employer contributions according to one of two vesting schedules: (i) three-year, cliff-vesting, in which the benefits of an employee who has three years of service are 100% vested, or (ii) six-year, graded vesting. I.R.C. § 416(b). If a qualified plan otherwise allows an employee to obtain his benefits upon termination of employment, the rapid vesting schedule merely encourages the employee to terminate his employment to obtain his vested retirement benefits and to "move on" and obtain a vested benefit in another plan. Thus, top-heavy plan status may become a key element in an employee's decision of whether or not to join or continue with a small company.

Conversely, if significant numbers of employers decide not to allow distributions upon termination of employment, then Congress inadvertantly has penalized rank-and-file employees by causing them to be unable to obtain their retirement plan benefits prior to retirement, death, disability, or hardship. This result is certain to occur, thereby creating additional administrative costs to the plan, such as recordkeeping and issuing reports to terminated employees who retain account balances.

F. The Top-Heavy Rules Encourage Small Business Employers to Engage in Economically Counterproductive Behavior. For example, the top-heavy plan rules both discourage an employer from promoting an employee to a position as a corporate officer and discourage that same employer from elevating a long-term, rank-and-file employee to ownership status through a stock participation program since, in either case, the employee may become a "key employee" whose accrued benefit or aggregate contributions account will "count against" the employer in a top-heavy plan analysis.

G. The Top-Heavy Rules Encourage Employers to Explore Employee Benefits Other Than Qualified Deferred Compensation Plans. Use of such other benefit programs will allow the employee/owner to shift his or her current medical, quasi-business, or insurance expenses to the corporation, thereby freeing other personal funds for use in his or her private retirement planning. The victim of this anti-top-heavy planning is the rank-and-file employee who cannot control the employer's benefit policy choices and who may not have the resources and sophistication which are necessary to take full advantage of private retirement planning. For example, even with individual retirement accounts, which are being adopted widely today, SBCA believes that future Internal Revenue

Service statistics, like those of past years, will show that only those participants with combined annual family incomes over $50,000 are able to contribute to any significant degree to individual retirement accounts.

H. Conclusions Regarding the Top-Heavy Plan Rules. Considering SBCA's six criticisms of the top-heavy plan concept and the various risks created by application of the top-heavy rules which are discussed above, Congress should postpone the implementation of the top-heavy rules at least until reliable empirical data is generated on the impact of the TEFRA pension provisions. The importance of this delay is easily illustrated. A quick response to SBCA's second criticism of the top-heavy rules, that is, that the rules will cause significant plan terminations, is that no reliable evidence quantifies the number of predicted plan terminations or evaluates the impact of those terminations on national social and economic policy goals. However, this response actually supports our recommendation that Congress delay implementation of the top-heavy rules until further study of their potential impact has been completed since Congress is accountable to the public for the results of Code Section 416 and, as yet, has no empirical data upon which to predict those results.

Because of the six significant disadvantages of the top-heavy plan rules discussed above and the lack of data which presently exists as to the potential impact of the rules, SBCA recommends that Congress repeal the top-heavy plan rules or, at the very least, delay implementation of the rules subject to their substantial revision.

III. Specific Criticisms of the Current Top-Heavy Plan Rules. In response to the Chairman Chafee's request for specific criticisms of the current top-heavy rules at the TEFRA Hearings, SBCA urges that the following provisions of Section 416, in addition to those provisions which were criticized earlier, be repealed or drastically modified.

A. Ownership Interest in the Employer. As noted, a "key employee" means, *inter alia*, any plan participant who at any time in the plan year or the last four plan years was one of the ten employees who owned the largest interest in the employer. I.R.C. § 416(i)(1)(A). One of the proposed regulations recently issued by the Service provides that "[a]n employee who has some ownership interest is considered to be one of the top ten owners unless at least ten other employees own a greater interest than that employee." Prop. Reg. § 1.416-1, T-12. Although this proposed regulation is a reasonable interpretation of this paragraph of Section 416, the regulation leads to absurd results in a case where several equal owners of a business exist.

For example, in a situation which is not untypical, suppose that twenty-five attorneys each own a four percent interest in a law firm. Regardless of the amount of each attorney's compensation and regardless of which attorney or attorneys actually control the operation of the law firm, all of the attorneys are key employees for purposes of the top-heavy rules. Therefore, SBCA recommends that this category of key employees be deleted entirely, especially since, in a small business, employees who are given a minimal amount of stock ownership as a part of a stock compensation program may be considered key employees despite the fact that, in substance, they are rank-and-file employees. Admittedly, the proposed regulations provide that an employee will not be considered to be a top ten owner for a plan year if he or she earns less than the maximum dollar limitation under Code Section 415(c)(1)(A). Prop. Reg. § 1.416-1, T-12. While this exception is commendable, it will not protect against all situations involving the facts which are discussed above since the maximum dollar limitation is drastically reduced by TEFRA.

In addition to the deletion of the "largest interest in the employer" category of key employees, SBCA recommends the deletion of the 5% owner category. The term "key employees" includes both a plan participant owning a greater than 5% interest in the employer and a plan participant owning a greater than 1% interest in the employer whose annual compensation from the employer exceeds $150,000. I.R.C. § 416(i)(1)(A)(ii),(iii). The 5% owner category should be deleted because modestly compensated rank-and-file employees, who TEFRA allegedly intended to protect, may be treated as key employees due to stock participation programs and because the 1% owner test will cover all of the owner-employees against whom Code Section 416 is aimed.

B. Rapid Vesting. As noted, a top-heavy plan must vest accrued benefits derived from employer contributions using either three-year, cliff vesting or six-year, graded vesting. I.R.C. § 416(b). However, the Service only recently was prevented from enforcing vesting schedules more stringent than the 4-40 vesting schedule in Public Law 97-12, Joint Resolution 325, and Joint Resolution 644. Since more rapid vesting of retirement plan benefits probably will have no significant revenue effect and since a more rapid vesting schedule does not apply exclusively to rank-and-file employees, Subsection (b) of Section 416 is an inexplicable reversal of past Congressional policy upon which a significant number of employers have relied in adopting qualified plans.

C. Plans Which Shift Between Top-Heavy and Non-top Heavy Status. Because Section 416 tests top-heaviness based on cumulative accrued benefits and aggregate account balances in defined benefit and defined contribution plans respectively, many plans of middle-sized companies conceivably may shift back and forth between top-heavy and nontop-heavy status from year to year. I.R.C. § 416(g)(1)(A)(i),(ii). This could occur for several reasons.

Since key employees will tend to be officers and owners of the employer and, thus, have a more permanent employment relationship than nonkey employees, a turnover rate for nonkey employees which is higher than the turnover rate for key employees is likely. Even though the group of key employees and the group of nonkey employees accrue the same benefits or receive the same contribution level each year, a plan may become top-heavy for the sole reason that the cumulative accrued benefits or accumulated aggregate account balances of key employees continue to increase while the benefits and accounts of the class of nonkey employees decrease due to normal employee turnover. Moreover, in times of recession, those employees who are not officers and owners admittedly are more likely to be discharged or laid off, thereby decreasing the total accrued benefits or aggregate account balances of the group of nonkey employees.

In either case, a plan which is not top-heavy in 1984 may become top-heavy in 1985 solely because of personnel changes not within the employer's control. One commentator has noted, as an alternative to the use of cumulative accrued benefits and aggregate account balances, that top-heavy status could be based on current-year accruals in a defined benefit plan and annual contributions to a defined contribution plan. Irish and Lent, "Tax Act Changes Rules Governing Top-Heavy Plans," Legal Times, October 11, 1982, p. 12.

Moreover, as this commentator noted, the problem of "creeping" top-heavy status may encourage employers to not allow lump-sum distributions. Key employees are not allowed to receive any distributions prior to the date upon which they attain the age of 59-1/2, without payment of a 10% penalty, unless the distributions are made on account of death or disability. I.R.C. § 72(m)(5)(A). Thus, an employer may forbid all lump-sum distributions to all employees prior to normal retirement age so as to retain the accrued benefits or accumulated account balances (as the case may be) of nonkey employees in an effort to prevent top-heavy status from developing.

D. Minimum Benefit Accruals. A top-heavy defined benefit plan must pay an annual retirement benefit derived from employer contributions to nonkey employee participants which at least equals the lesser of (i) two percent of the participant's average compensation per year of service or (ii) twenty percent, multiplied by the employee's average annual compensation during his or her highest consecutive five years. I.R.C. § 416(c)(1); Prop. Reg. § 1.416-1, M-2 through M-5. This requirement materially accelerates the annual accrual percentage required by ERISA and typical in most defined benefit plans.

For example, a defined benefit plan which provides a benefit equal to twenty percent of pay upon normal retirement at age sixty-five will have forty years to accrue the maximum benefit for a twenty-five year-old participant. If the plan is top-heavy, then the twenty percent benefit must be accrued in ten years. Congress has failed to consider that benefit accruals are an employer cost and that the increased cost may simply be too much for many small employers. This rule also results in the odd circumstance of a participant's accrued benefit remaining the same after his or her benefit reaches 20% even though the participant remains an employee for several years thereafter. This result eliminates the incentive for long-term employment and produces the necessity for job shopping.

Moreover, in the top-heavy rules, Congress has now effectively outlawed qualified defined benefit plans which are top-heavy that provide a benefit of less than twenty percent of pay, perhaps preventing a significant number of employers from providing the minimal level of retirement benefit which they and their benefit consultants believe they can afford.

Also, in a recent speech to the 13th Institute, Mr. William E. Lieber, Pension Tax Specialist for the Joint Committee on Taxation, stated that the minimum benefit accrual rules "were a proxy for changes in the integration rules." However, he also noted how surprised several members of the House Ways and Means Committee were to learn from the testimony on H.R. 6410 that a female employee, aged 35 and earning $30,000 a year, could be integrated out of the qualified defined benefit plan of a large national corporation. Unfortunately, the minimum benefit accruals enacted by Congress in TEFRA do not address this problem since a large national corporation may still exclude rank-and-file employees who earn less than the Social Security wage base because such an employer will not be subject to the top-heavy rules of Code Section 416. In this regard, Congress may have hit the mouse when it intended to shoot the elephant.

E. Super Top-Heavy Rules. TEFRA eliminates the "1.4 Rule" for employees who participate in both a defined contribution and defined benefit plan provided by the same employer. TEFRA substitutes a much more complex calculation, the "1.25 Rule," which is further lowered to a "1.0 Rule" for super top-heavy plans. I.R.C. § 416(h)(1). A super top-heavy plan essentially is a plan which would be top-heavy even if a 90% test were substituted for the 60% test used to define top-heavy plans. See I.R.C. § 416(h)(2). Absolutely no justification exists for this added penalty on very small employers and no reasonable justification has been advanced. Thus, even if Congress is unwilling to repeal Code Section 416 in its entirety, the super top-heavy plan rules certainly should be repealed.

IV. Conclusion. The top-heavy plan rules represent a direct and blatantly discriminatory attack by Congress on the retirement plans provided by small businesses. Attacking any specific group of employers or any specific group of corporate employers is not justified; however, penalizing small employers without any evidence of blameworthiness and without a clear understanding of the detrimental effects on the pension benefits of millions of participants in small plans is the true inequity of Code Section 416. The discrimination between large and small employers which Code Section 416 accomplishes is so lacking in rationale and social and economic justification that Congress will be forced to view Code Section 416 as unwarranted discrimination between taxpayers. Therefore, SBCA recommends that Code Section 416 be repealed in its entirety since it represents blatant discrimination against small businesses in the federal income tax laws. As an acceptable but inferior alternative, SBCA recommends that implementation of Section 416 be delayed until substantial revisions can be recommended to Congress based upon empirical data developed in studies by the General Accounting Office, the Treasury Department, and the Joint Committee on Taxation.

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April 25, 1983

The Honorable John H. Chafee
United States Senate
Subcommittee on Savings,
Pensions and Investment Policy
Committee on Finance
Room SD-4221
Dirksen Senate Office Building
Washington, D.C. 20510

Re: April 11, 1983 Subcommittee Hearing -- Effect of Changes Made in the Tax Equity and Fiscal Responsibility Act of 1982 on the Private Pension System

Dear Mr. Chairman:

On behalf of the Western Conference of Teamsters Pension Trust Fund (the "WCT Plan"), we respectfully submit this statement for consideration by the Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance, in connection with the above hearing and for inclusion in the printed record of that hearing. The WCT Plan is the largest multiemployer pension plan in the United States. At present, the WCT Plan receives contributions on behalf of more than 500,000 employees working under Teamster collective bargaining agreements with nearly 15,000 employers in thirteen Western states, and pays retirement benefits to over 100,000 persons. The WCT Plan is administered by 28 trustees jointly representing management and labor pursuant to the Labor-Management Relations Act, 1947.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") will affect the WCT Plan and its participants and contributing employers in several ways. This statement focuses solely on one major effect of the new requirements relating to distributions from qualified plans. Section 401(a)(9) of the Internal Revenue Code, as amended by TEFRA to be effective in 1984, will not permit benefits to be paid to minor or disabled children (or any other beneficiary except for the surviving spouse)*/ for more than five years after the participant's premature death. For example, under this new restriction, if a participant dies when his or her child is two years old, benefits may not be paid after the child is seven. Benefits may be paid after that time to a surviving spouse, if any, but not specifically on behalf of a minor or disabled child. Indeed, it appears that TEFRA does not even permit a plan to purchase and distribute an annuity contract within the five-year period in order to provide more regular financial support for that child.**/

We strongly believe that this restriction runs against basic humanitarian and social policy considerations. Moreover, this restriction will neither increase tax revenues nor promote the sound administration and operation of pension plans. Many plans, including the WCT Plan, may have to substantially eliminate child benefits currently being paid. For example, the children of a deceased WCT Plan participant may now receive a survivor's benefit of up to $307 per month.***/ Children are eligible if they are under 18 or if they are physically or mentally disabled prior to age 18 and continue receiving Social Security disability benefits after age 18. In the absence of such continued disability, payments cease when a child reaches age 18. Benefits are nominally paid to the surviving parent or the child's guardian, but are expressly designated as for the care and maintenance of the child.

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*/ Even the surviving spouse exception could be questioned because of the awkward language of section 401(a)(9), but we understand that it is intended that the statute be interpreted to continue this exception.

**/ See General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, p.312 (Joint Comm. Tax. Staff, Dec. 31, 1982).

***/ In order for a surviving child to receive benefits, the participant must have 3,000 or more covered hours in the five year period preceding his or her death, and the participant's employer must contribute at a rate of more than $.21 per covered hour (as substantially all employers do). The 3,000 hours requirement will probably be met if the participant worked full-time in covered employment for the two years immediately prior to death. Significantly, a participant does not have to be vested with regard to pension benefits in order for survivor benefits (which are ancillary benefits) to be paid to his or her children.

More than 2,000 children currently receive survivor benefits under the WCT Plan; 2,143 children who are under 18 years of age and 120 disabled children who are 18 or over.

The distribution restrictions of TEFRA were among many provisions added in Conference under extremely rushed circumstances that did not permit full consideration of the relevant social and tax policy implications. We see no reason why any restriction should be imposed on payments to minor and disabled children. If the purpose of the new distribution requirements is to prevent participants from accumulating large amounts under a plan and distributing those monies free of tax to their beneficiaries, this same purpose has already been achieved, in a much more efficient manner, by TEFRA's new limit on the estate tax exclusion for interests in qualified plans. If the purpose is to increase tax revenues, precluding long-term payments to surviving children is an extreme means to achieve a truly insigificant revenue gain, if any. In this regard, if a plan complies by reducing child benefits, these amounts will simply remain in the plan's tax-exempt trust for other benefits. If, instead, benefits are increased within the permissible five-year period, a small amount of taxes may be payable by the child (thereby reducing the net benefit), but at the enormous social cost of risking the child's future security. A lump-sum (or five-year) payout subjects a child to the substantial risk that benefits may not be prudently and effectively conserved for the child's continued support.

Finally, if the purpose of the new restrictions is to prevent manipulation of plan provisions in favor of certain key employees, that purpose is in no way served by eliminating long-term benefits to minor and disabled children. On the contrary, we believe that these benefits provide the greatest comfort, and therefore have the greatest value, to lower-paid employees. These persons are more likely to have insufficient resources to provide for their children in the event of untimely death.

The Federal government has determined that surviving minor and disabled children of working Americans merit public support through the Social Security system. There are no strong tax policy or other reasons why the private sector should be precluded from supplementing that public support. We believe that WCT Plan child benefits provide extremely important financial support for many, if not all, of the over 2,000 children who currently receive survivor benefits. We see no reason why any plan should be precluded from providing long-term financial support for surviving minor children, or for retarded or physically disabled older children, of prematurely deceased participants.

We therefore ask that an exception to the new distribution rules be provided for surviving children who are eligible to receive Social Security benefits because of the death of a parent. Attached to this statement is a draft of a simple technical amendment that would accomplish this result. Thank you for your consideration of this matter.

Very truly yours,

Louis T. Mazawey

Enclosure

April 25, 1983

SEC. ______ BENEFITS FOR SURVIVING CHILDREN

(a) BENEFITS TO SURVIVING CHILDREN PERMITTED. -- Section 401(a)(9)(B) of the Internal Revenue Code of 1954, as amended by the Tax Equity and Fiscal Responsibility Act of 1982, is amended by deleting the period at the end thereof, and inserting in lieu thereof ", or to the extent that the plan provides for payments from the trust to any child of the participant who is eligible to receive Social Security benefits on account of the participant's death."

(b) EFFECTIVE DATE. -- The amendment made in this section shall apply to plan years beginning after December 31, 1983.

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